REPORT BY THE SENIOR CITIZENS CIRCUIT BREAKER TAX CREDIT REVIEW SUBCOMMITTEE

November 4, 2010

Subcommittee Members:

Chairman, Craig A. Van Matre

Alan Marble	Dee Joyner
Penny Rector	Representative Tim Flook

Missouri Tax Credit Review Commission

Report of the Senior Citizen Circuit Breaker Tax Credit Review Subcommittee

What follows in this memorandum is the report and recommendations of the Senior Citizens Circuit Breaker Tax Credit Subcommittee (the "Subcommittee") which is hereby submitted to the Tax Credit Review Commission (the "Commission") on November 4, 2010. This Report and the attachments hereto have been submitted in the hope that it will give the Commission guidance and explain the Subcommittee's reasoning in making the recommendations which hereafter follow.

I. Introduction

The Senior Citizens "Circuit Breaker" Tax Credit is governed by Sections 135.010 through 135.030 of the Revised Statutes of Missouri (the "Credit"). The Credit may be claimed by senior citizens, disabled Veterans, persons who are 100% disabled, and certain widows and widowers.[1] A "claimant" of the Credit must meet specified criteria in order to claim the Credit. However, the Credit may be claimed only if the eligible claimant either owns or rents a residential dwelling. The Credit first became effective for calendar year 1973[2] and was last modified by Senate Bill No. 711 in 2008. The eligibility of tenants ("Renters") to claim the Credit has existed since the date the statute first was enacted.

The Credit gradually phases out as a claimant's income increases such that once a claimant's income (as adjusted) exceeds $30,000 for individual property owners and $27,500 for Renters, no credit can be claimed. If the claimant's income is less than $14,300, then the full Credit is awarded, assuming property tax liability meets or exceeds the credit amount. The Credit phases out as income rises from this minimum base of $14,300 to the "maximum upper limit" specified in the statute.[3] The Missouri Department of Revenue has promulgated a number of explanatory documents including a chart which helps with the computation of the credit to which a claimant may be entitled. Copies of these helpful DOR documents are attached.[4] When the Commission was first constituted, this Credit was not on the list of credits to be examined and reported on by the Commission. After the Commission's creation, and on or about October 21, 2010, the decision was made to add to the Commission's tasks recommending whether the Credit should be modified.

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[1] Section 135.010(1) RSMo.

[2] HB 149 (1973).

[3] Section 135.030 RSMo.

[4] See attachments 2, 3, and 4 to this Report.

A. **Purpose:** The purpose of the Credit cannot be gleaned from any legislative history. However, it seems obvious that Missouri's motivation in adopting the Credit was not that different than the motivation influencing approximately 18 other states in the U.S. which have adopted other programs to ameliorate the effect of real estate taxes on senior citizens. The typical explanation of a "circuit breaker" tax credit such as Missouri's is as follows:

> "Property tax circuit breakers, like the electrical devices that shut off electric power to prevent circuits from overloading, prevent property taxes from "overloading" a family budget by "shutting off" property taxes once they exceed a certain share of the family's income."[5]

Programs similar to the Credit are offered in 18 states in a variety of different forms and with different criteria.[6] The primary impetus for such programs is the perceived unfairness (disproportion) of the real estate taxes paid by low income families. In 2002, low income families paid an average of 3% of their income in property taxes whereas wealthy taxpayers paid less than 1%.[7] Accordingly, circuit breaker programs are designed to ameliorate this disproportion.

Presumably the addition of Renters to this Credit was based on the belief that some component of rent is attributable to the real estate taxes payable by the landlord.

The most sympathetic example given as the rationale for property tax relief is an elderly couple who has lived in their house for a long time and who finds the increase in property taxes over the years increasingly burdensome because they are living on a fixed income. The hope is that the relief will allow that couple to remain in their residence.

B. **Nature of Credit:** The Credit is not an economic development credit, but rather is a social welfare type credit. However, a good argument can be made that by providing the funds which allow property tax payers to remain in their residences also benefits the current economy of the state by not adding another residence to the long list of dwellings for sale during the current recessionary period. Economic studies seem to indicate that for every $100 increase in annual property taxes, there is a 0.76% increase in the average two-year mobility rate of senior citizens.[8]

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[5] Lyons, Farkas, and Johnson, *The Property Tax Circuit Breaker: And Introduction and Survey of Current Programs*, Center on Budget and Policy Priorities, March 21, 2007.

[6] Id. at page 2.

[7] Institute on Taxation and Economic Policy, *ITEP Guide to Fair State and Local Taxes*, February 2005.

[8] Shan, *Property Taxes and Elderly Mobility*, Finance and Economic Discussion Series, Divisions of Research and Statistics and Monetary Affairs, Federal Reserve Board, 2008-50.

Economists consider this increase to be economically significant. However, it is not possible to refine the data to eliminate all other possibilities. Nevertheless, at least intuitively and empirically, it makes sense that if a homeowner wishes to remain in his or her residence, lacks the ability to do so but for a government subsidy, and the cause of the economic distress is sufficiently compelling, that government has a role to play. Thus, in this circumstance, not only the societal goal of preserving homesteads for elderly citizens as well as the beneficial economic effect of doing so are reasons to support this Credit.

The Credit's benefits are much more difficult to ascribe to the component of the Credit attributable to reimbursing Renters. It is impossible to ascribe to that portion of the Credit paid to tenants any beneficial economic effect (except, of course, to the extent that it allows certain landlords to maintain higher rents than might otherwise be the case).

C. **Statistical and Anecdotal Information:** Attached to this report are summaries of financial data obtained from the Missouri Department of Revenues database as to persons claiming the Credit and the economic effect of the Credit upon the state in calendar years 2008 and 2009. Similar statistics are available for previous years, but the two years of data attached provide meaningful insights into how this Credit works and reasonable inferences to be drawn, to-wit:

1. In 2008, the credits claimed under the Circuit Breaker statute totaled $114,536,560. These credits were utilized slightly more by Renters than by property owners. In 2008, $59,197,314 of the credits were claimed by Renters versus $53,886,455 by property owners.

2. In 2009, the percentage of credits claimed by owners and Renters was nearly identical. A total of $115,891,430 of credits were claimed, $56,638,297 by Renters, and $57,837,289 by owners.

3. Of particular significance is the fact that in 2008, that portion of the credits claimed by Renters, claims filed by 100% disabled persons were in greater dollar amounts than those who were senior citizens ($31,206,102 versus $26,991,902). Conversely, owners of residences based their claims on being senior citizens instead of being disabled ($45,288,025 of credits for seniors versus only $7,286,145 based on disability). The "significance" of this statistic is that it implies that even though they are much smaller in number, disabled persons are completing and filing claims much more frequently than seniors. This, in turn, implies that they are receiving assistance in doing so. The Subcommittee believes that it is reasonable to assume that the various nursing homes and assisted living facilities within the state that are for-profit make it a practice to encourage their residents in this regard. Finally, the Subcommittee believes that those residential facilities that engage in this practice probably are facilities that have benefitted under other state tax credit programs. Thus the Subcommittee believes that the DOR should try to discern from its database whether these suspicions are well-founded, and if so, furnish those

statistics to the Governor and Legislature so that the new policies governing the Renters' Credit or equivalent benefit can be informed by same.

4. Anecdotal reports communicated to both the Department of Revenue and to various legislators indicate that many persons claim the Credit only after being assisted in filling out the necessary paperwork by representatives of the particular residential complex in which they are a tenant. These same anecdotal reports indicate that the amounts of these credits (when collected) are turned over to the various nursing homes, apartment units, etc., as payments towards rent otherwise due (or perhaps in addition).

5. The Credit currently costs the state more than $115,000,000 per year. It is projected that it will do so for the foreseeable future if it is not modified.

6. There are other housing assistance programs designed to address the same apparent need that the Renters' Credit addresses. Such programs are the Low Income Housing Tax Credit, federal, state, and local assistance programs, etc. The risk that eliminating the Renters' Property Tax Credit would result in the loss of a residence to a disabled or senior tenant seems to be minimal given the existence of these alternate programs.

II. **Recommendation**

The Subcommittee recommends that the portion of the Credit which benefits Renters be eliminated or substantially modified. Accordingly, the Subcommittee believes that the priority category of the Credit is category "B," i.e., a tax credit which, if continued, needs modification. Benefits accruing to Renters under this Credit need to be replaced with a different structure as hereafter described. The Subcommittee does not believe that the portion of the Credit which grants benefits to homeowners who are senior citizens, disabled, or who otherwise are eligible for benefit under the Credit should be modified. Instead, the credits for property owners should be preserved as presently structured. The Subcommittee believes that the portions of the Credit which define the benefit available to senior citizens, disabled veterans, 100% disabled persons, and widows/widowers, and who are owners of residential dwellings are well written, well administered, and do not require modification. Accordingly, what follows in the balance of this report is a discussion of the considerations involved in eliminating, restructuring, or substantially modifying the Credit as it applies to Renters.

III. **Discussion of Alternatives**

The Subcommittee recognizes that its recommendation as set forth above will generate consternation in many circles. The Subcommittee is not unmindful of the pressing need many persons have who rent and do not own their dwellings. The Subcommittee's recommendation of a modification to the benefits afforded these persons is not intended to denigrate or minimize the financial distress many of them experience on a day-to-day basis; rather the Subcommittee hopes that

any benefit provided to these persons will be rationalized, equalized, and structured to conform to a clear legislative intent and purpose. As presently structured, the Credit's benefits to tenants are unequal and do not appear (to the Subcommittee at least) to have a sufficient basis to be continued in its present form.

A. **Present Credit Structure for Tenants:** Renters have been beneficiaries under this statute since the date of its inception. In 1972, Missouri voters approved a Constitutional amendment (Article X, Section 6(a) to the Missouri Constitution) which allowed the General Assembly to "provide for certain tax credits or rebates" for payments of real property taxes in the form of "comparable financial relief . . . [to those benefits afforded homeowners] to persons . . . who occupy rental property as their homes." In 1973, the General Assembly created the Senior Citizen Property Tax Credit Program. Under this original program, owners of homesteads and Renters making less than $7,500 could claim a credit of up to $400 to offset property taxes accrued or rent constituting property taxes accrued. "Rent" was defined as being 18% of the gross rent paid by the claimant.

In 1982, voters amended the Constitution to strike the age qualification of 65 from this Section. The General Assembly subsequently expanded the Credit to persons who were disabled veterans, 100% disabled individuals, and claimants 60 years or older who receive surviving spouse social security benefits, and later increased the minimum base and maximum upper limit of income under the program. In 2008, the general assembly expanded the benefits of the program for owners of homesteads by raising the income exemption from $2,000 to $4,000 and increasing the maximum award to $1,100 to homeowners, but leaving the then maximum award at $750 for Renters. The 2008 amendments to the statute did not benefit Renters, but did not reduce those benefits either.

B. **Anomalies Under the Statute:** Renters entitled to claim the Credit are only those persons who pay "arms length" rental to landlords during the year.[9] The Credit is <u>not</u> available if the landlord does not pay real estate property taxes.[10] The Credit for Renters is (at least initially) equal to 20% of the gross rents paid by the Renter to the landlord.[11] These criteria prompted the following comments and concerns from the Subcommittee:

1. There does not appear to be any rational relationship between the 20% of gross rent paid and the actual property taxes attributable to that tenant's rent. Among the Subcommittee members, it was the common belief that much less than 20% (and probably less than 10%) of a tenant's rent would be attributable to that Tenant's share of real estate taxes due with respect to the property rented.

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[9] Section 135.010(3) RSMo.

[10] Missouri Department of Revenue "Frequently Ask Questions;" 2009 Form MO-PTC, Line 10; 2009 Missouri Property Tax Credit Claim Instructions MO 860-1782 (10-2009), page 2.

[11] Section 135.010(7) RSMo.

2. Many nursing homes, assisted living facilities, and apartments for older adults are owned by non-profit corporations or associations. None of these tenants would be eligible to claim the Credit even though their incomes would be similar to those allowed to claim the Credit.

3. Rent in a particular market is determined by many factors (supply and demand, competition, land costs, utility costs, costs of providing additional services, municipal services, etc., etc.). The Subcommittee does not believe that property taxes have any significant effect on rents; rather landlords tend to charge as much as the market will allow them to charge and still maintain relatively full occupancy.

4. Real estate taxes on apartments vary widely throughout the state, and each area's property tax rates vary as well. The Credit is a "one size fits all" Credit which does not differentiate based on true economic circumstances of Renters in a particular vicinity.

5. Many of the facilities which provide housing to Renters who qualify for the Credit are facilities which enjoyed the low-income housing tax credit (state and federal) and perhaps the historic rehabilitation tax credit (state and federal). Other credit programs also may have been applicable to the facility. These tax credits were designed to reduce the cost of the low-income housing facility for elderly or disabled tenants, and thus, in a very real sense, the tenants in those facilities are already receiving the benefit of the state's contribution towards their housing costs. The Subcommittee did not believe that it was appropriate for tenants in facilities whose rent is already subsidized (through other tax credit programs) to be able to benefit under this Credit as well.

6. In short, the Renters able to claim the Credit do not represent a fair distribution of persons throughout the state similarly situated; instead they are persons who have been arbitrarily selected by the language of the statute for the Credit's benefit, even though others virtually identically and similarly situated lease their dwellings from non-profit (property tax exempt) landlords.

C. **True Purpose of Renter's Credit:** The Subcommittee believes that it is not reasonable to conclude that there is a logical and consistent nexus between property taxes paid by a for-profit landlord and the need to provide a subsidy to that landlord's tenants. Instead, a Renter's use of the Credit should be seen for what it is, i.e., a subsidy to lower income persons who meet the criteria of either being disabled or over 65, even though other persons in the same economic circumstance are not eligible for a similar benefit. Thus the Subcommittee believes that if a subsidy is to be provided to persons close to the poverty line or below it, then that subsidy ought to be a grant which is subject to the appropriation process and which achieves what the legislature and Governor believe is its rightful priority among all of the other funding needs of the state. Arbitrarily selecting that benefit for only those persons who rent from for-profit landlords, even though they are already living in a rent assisted facility, does not make economic sense.

D. **Alternatives:** The Subcommittee does not believe that the elimination of the Credit in favor of Renters should occur without there being some attempt to reconcile and ameliorate the distressed economic condition of the poorest among us. Such a grant program could be administered in the same manner as a tax credit program, but be subject to the appropriations process. A rent subsidy for non-property owners who pay rental may be appropriate in this regard, but perhaps tenants in low-income housing tax credit type developments should be ineligible to claim this benefit. Perhaps the benefit should be awarded regardless of where the tenant lives if the income that tenant receives is sufficiently low. In any event, the Subcommittee considered possible modifications to the existing Credit scheme for Renters in lieu of a complete termination of a Renters' credit, to-wit:

1. The Renters credit could be reduced such that only 10% of a tenant's gross rent was taken into account up to a maximum of $500. This approach would be simple, but would perpetuate the problems with the Credit described above, even though at a lower level of reimbursement.

2. Tenants living in housing developments built with the use of low-income housing tax credits might be deemed ineligible to claim the Credit.

3. A formula could be devised whereby only the actual component of the tenant's rent which was truly attributable to real estate taxes would be taken into account. This would require the disclosure by the landlord of the landlord's gross rents received from all tenants as well as the landlord's actual real estate taxes paid. Many landlords might be uncomfortable in or unwilling to divulge this information. Such information might very well lead to a reassessment of the landlord's property if the landlord were required to divulge that information to any tenant, and in order to make such a formula workable, a landlord would have to be required by statute to make that disclosure.

E. **Rejected Alternatives:** The Subcommittee discussed, considered, but ultimately rejected the following additional modifications to the Credit, to-wit:

1. The possibility that some claimants might have a substantial net worth and yet low adjusted gross income was considered. In other words, the Subcommittee considered whether to recommend that a "means test" be introduced so that persons whose net worth was sufficiently large would not be eligible for the Credit, regardless of the amount of their adjusted gross income. Alternatively, the Subcommittee considered whether to disallow the Credit if the Credit was going to be applied to a sufficiently valuable residence. Ultimately, the Subcommittee rejected both of these approaches because verifying a claimant's net worth or determining whether a particular residence was "too valuable" would involve a substantial bureaucratic expense, and it was the impression of the Subcommittee that these type of abuses would be relatively small in number and therefore not very costly to the state.

2. Another approach considered by the Subcommittee was to disallow cash refunds below a certain dollar amount, i.,e., require that before a check would be issued by the Department of Revenue, the amount of refund or distribution amount be sufficiently large to warrant the cost of preparing the check. However, the Department of Revenue members advises that the cost of processing a claim under the Credit is about $2.50 per refund (credit) check issued. The Subcommittee did not consider this cost to be sufficiently large to warrant any type of threshold for a refund.

3. The Circuit Breaker Tax Credit burdens the state while at the same time benefitting local governments. The property tax which is related to the Circuit Breaker Credit is an important source of revenue for local governments. By allowing the local governments to keep the real estate taxes that the state refunds through this Credit is, in effect, an indirect subsidy by the state of local governments. The Subcommittee considered whether there should be some sharing of the cost of these credits by requiring that some portion of the Credit attributable to a particular local government be refunded to the state by the local government. This approach ultimately was rejected because of the fact that most property taxes benefit elementary and secondary public schools, and a reduction in property taxes paid to those schools would, in the final analysis, have to be made up by the state anyway. The utility of reducing the local government's share of property taxes would be nonexistent.

IV. **Conclusion**

Perhaps it is a measure of the desperate financial straits in which the State of Missouri now finds itself that we must seriously consider cutting a state benefit to those who are truly the "least among us."[12] Of course this reduction in aid presumes that there are literally no other sources more deserving of reduction or elimination than this Credit. The Subcommittee does not believe this to be the case, i.e., while the Subcommittee believes that the Credit in favor of Renters should be revised, studied, and more directly and fairly apportioned, it does not mean that the Subcommittee advocates cutting benefits to this class and demographic of persons. Instead, the Subcommittee recommends that a considerable refinement and more precise targeting of these funds be considered and that the senior citizen property tax credit benefit only those persons who are homeowners.

Respectfully submitted,

Members of the Senior Citizens Tax Credit Subcommittee
Craig A. Van Matre
Alan Marble
Dee Joyner
Penny Rector
Representative Tim Flook

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[12] Christian Bible, Matthew 25:40.

LIST OF ATTACHMENTS
TO REPORT BY
SENIOR CITIZENS CIRCUIT BREAKER TAX REVIEW SUBCOMMITTEE

1. Property Tax Credit statutory language
2. Eligibility Chart, Property Tax Credit, Missouri Department of Revenue
3. Missouri Department of Revenue, FAQs, Property Tax Credit
4. Missouri Property Tax Credit Claim Instructions, MO 860-1782 (10-2009)
5. Property Tax Credit Utilization Statistics, 2007-2009
6. Lyons, Farkas, and Johnson, *The Property Tax Circuit Breaker: And Introduction and Survey of Current Programs*, Center on Budget and Policy Priorities, March 21, 2007
7. Institute on Taxation and Economic Policy, *ITEP Guide to Fair State and Local Taxes*, February 2005
8. Shan, *Property Taxes and Elderly Mobility*, Finance and Economic Discussion Series, Divisions of Research and Statistics and Monetary Affairs, Federal Reserve Board, 2008-50
9. Historical materials related to enactment of the Property Tax Credit

AM I ELIGIBLE?

Use this diagram to determine if you or your spouse are eligible to claim the

PROPERTY TAX CREDIT

START DIAGRAM BY CHOOSING BOX 1 OR BOX 2 AND FOLLOW TO CONCLUSION.

1 **RENTERS / PART YEAR OWNERS --** If **single**, is your total household income $27,500 or less? If **married filing combined**, is your total household income $29,500 or less? If you are a 100% service connected disabled veteran, do not include VA payments.

NO → NOT ELIGIBLE

YES

OR

2 **OWNED AND OCCUPIED YOUR HOME THE ENTIRE YEAR --** If **single**, is your total household income $30,000 or less? If **married filing combined**, is your total household income $34,000 or less? If you are a 100% service connected disabled veteran, do not include VA payments.

NO → NOT ELIGIBLE

YES

Did you pay real estate taxes or rent on the home you occupied?

RENTERS: If you rent from a facility that does not pay property taxes, you are not eligible for a Property Tax Credit.

NO → NOT ELIGIBLE

YES

Can you truthfully state that you do not employ illegal or unauthorized aliens?

NO → NOT ELIGIBLE

YES

Were you or your spouse 65 years of age or older as of December 31, 2009, and were you or your spouse a Missouri resident the entire 2009 calendar year? If so, check **Box A** on Form MO-PTC.

YES → ELIGIBLE; NO →

Are you or your spouse 100 percent disabled as a result of military service? If so, check **Box B** on Form MO-PTC.

YES → ELIGIBLE; NO →

Are you or your spouse 100 percent disabled? If so, check **Box C** on Form MO-PTC.

YES → ELIGIBLE; NO →

Were you 60 years of age or older as of December 31, 2009, and did you receive surviving spouse social security benefits? If so, check **Box D** on Form MO-PTC.

YES → ELIGIBLE; NO → NOT ELIGIBLE

E L I G I B L E

N O T E L I G I B L E

This information is for guidance only and does not state complete law.

2-D Barcode Returns — If you plan on filing a paper return, you should consider 2-D barcode filing. The software encodes all your tax information into a 2-D barcode, which allows your return to be processed in a fraction of the time it takes to process a traditional paper return. If you use software to prepare your return, check our web site for approved 2-D barcode software companies. Also, check out the department's fill-in forms that calculate and have a 2-D barcode. **ALL** 2-D barcode returns should be mailed to: **Department of Revenue, P.O. Box 3385, Jefferson City, MO 65105-3385**.

Missouri Department of Revenue

Jay Nixon, Governor
Alana M. Barragán-Scott, Director

Property Tax Credit Claim

What is a Property Tax Credit (MO-PTC)?
Who qualifies for the credit?
What is the income limit?
What if my spouse lives in a nursing home or assisted living facility?
What is considered household income?
Is my spouse's income included in household income?
What if I share my residence with someone?
Are payments for dependent children living in the home included in household income?
How do I file for the credit?
When is my claim due?
Can I file a previous year's claim?
What documentation is required?
How do I obtain my paid personal property and/or real estate tax receipt(s)?
Can I file for a deceased individual?
Can I get credit for sewer lateral or any other fees included on my property tax statement?
Can I get credit for a home I own but do not occupy?
If my home sits on 10 acres of land, can I get a credit for all of the real estate taxes paid?
If the facility that I am living in does not pay real estate tax due to being tax exempt do I qualify?

What is a Property Tax Credit (MO-PTC)?

Tax Years 2008-2009:

Certain individuals are eligible to claim up to $750 if they pay rent or $1,100 if they pay real estate tax on the home they own and occupy. **If you rent from a facility that does not pay property taxes, you are not eligible for a Property Tax Credit.**

Tax Year 2007:

Certain individuals are eligible to claim up to $750 if they pay rent or pay real estate tax on the home they own and occupy.
Note: A 2007 claim must be filed by April 15, 2011, or a refund will not be issued.

back to top

Who qualifies for the credit?

Individuals who meet one of the following qualifications:

Claimant or spouse must be 65 years of age or older on or before the last day of the calendar year and a resident of Missouri for the entire year;
Claimant or spouse is a veteran of any branch of the armed forces of the United States, or this state and is 100 percent disabled as a result of such service;
Claimant or spouse is 100 percent disabled; or
Claimant has reached age 60 on or before the last day of the calendar year and is receiving surviving spouse social security benefits.

back to top

What is the income limit?

Tax Years 2008-2009:

Renters/Part Year owners:
If **single**, your total household income must be $27,500 or less.
If **married filing combined**, your total household income must be $29,500 or less.
Owned and Occupied your home the entire year:
If **single**, your total household income must be $30,000 or less.
If **married filing combined**, your total household income must be $34,000 or less.

Tax Years 2007:

Total household income must be $25,000 or less if filing single or $27,000 if married filing combined.
Note: A 2007 claim must be filed by April 15, 2011, or a refund will not be issued.

back to top

What if my spouse lives in a nursing home or assisted living facility?

Tax Years 2008-2009:

If you did not live together for the entire year, you may file separate claims but the income limit is $27,500 for each spouse.

Tax Years 2007:

If you did not live together for the entire year, you may file separate claims but the income limit is $25,000 for each spouse.

Note: A 2007 claim must be filed by April 15, 2011, or a refund will not be issued.

back to top

What is considered household income?

Missouri adjusted income as defined in Section 143.121, RSMo and increased to reflect the following:

Social security and railroad retirement;
Veteran payments and benefits unless the claimant or spouse is a 100 percent disabled as a result of military service;
All other public and private pensions and annuities;
Public relief, public assistance, and unemployment benefits received;
SSI, TANF and/or child support payments received;
Non-business losses;
Wages, dividends, and interest;
Rental income.

back to top

Is my spouse's income included in household income?

Yes. The income for both spouses must be included as household income.

back to top

What if I share my residence with someone?

If two or more unmarried adults share a residence, and each pay part of the rent, only the portion paid by the claimant can be claimed. If one person pays the entire amount, a percentage of 100% will need to be taken on Form MO-CRP.

back to top

Are payments for dependent children living in the home included in household income?

Yes. All payments for dependent children living in the home must be included as household income.

back to top

How do I file for the credit?

If you are required to file a Missouri Individual Income Tax Return, you must use Form MO-1040 or Form MO-1040P with a Property Tax Schedule (MO-PTS) attached.

If you are not required to file a Missouri Individual Income Tax Return, then you may file the Missouri Property Tax Credit Claim (MO-PTC).

If you are unsure which form best meets your filing needs, use our Personal Tax Form Selector.

back to top

When is my claim due?

Your claim is due April 15th.

back to top

Can I file a previous year's claim?

You have three years from the original due date to file a claim.

back to top

What documentation is required?

The following documentation is required (as applicable):

Copy of paid real estate tax receipt;
All 1099 forms;
All W-2 forms;
Letter from Veterans Administration;
Letter from Social Services, Division of Family Services (DFS), and/or Employment Security;
Letter from Division of Child Support Enforcement (DCSE);
Assessor Certification (Form 948);
Lease agreement, rent receipts, or letter from landlord;
Form MO-CRP.

back to top

How do I obtain my paid personal property and/or real estate tax receipt(s)?

Your county collector's office or the city of St. Louis (leaving dor.mo.gov webspace) sent you receipts when you paid your **personal property and/or real estate taxes**. (If you have lost your receipt(s), please contact your county collector or the city of St. Louis collector of revenue.)

You must provide a copy of your receipt(s) (photocopy, fax copy, or copy of an internet confirmation screen is acceptable) when applying for the Homestead Preservation Credit and the Missouri Property Tax Credit Claim. Applicants may receive only one of the credits in the same calendar year.

back to top

Can I file for a deceased individual?

A claim may be filed by the surviving spouse if the filing status is "married filing combined" and all other qualifications are met. If there is no surviving spouse, the estate may file the claim.

A copy of the death certificate must be attached and if the check to be issued in another name, a Federal Form 1310 must also accompany the claim.

Any existing "Power of Attorney" (POA) pending with the Department of Revenue is terminated when the death of the taxpayer is made known to the Department. A new POA (Form 2827) is required after death of the taxpayer before any party may discuss the taxpayer's debt with the Department staff.

back to top

Can I get credit for sewer lateral or any other fees included on my property tax statement?

No. Sewer lateral, penalties, interest, and other fees are local fees. They must not be included when claiming a property tax credit.

back to top

Can I get credit for a home I own but do not occupy?

No. The property tax credit can only be received for a home that you occupy.

back to top

If my home sits on 10 acres of land, can I get a credit for all of the real estate taxes paid?

You can get a credit for up to five acres on which your home sits. If you have more than five acres, you must include an Assessor Certification (Form 948) indicating the amount of tax paid on five acres and your homestead.

back to top

If the facility that I am living in does not pay real estate tax due to being tax exempt do I qualify?

No. According to Section 135.010 of the state statutes, the Property Tax Credit can only be claimed by a person who lives on or pays rent on a property on which property tax is paid. If a person , group or governmental entity doesn't pay any property tax on a property, no one living on that property can claim the credit.

back to top

Can't find an answer to your question(s)?
Email us! PropertyTaxCredit@dor.mo.gov

MISSOURI DEPARTMENT OF REVENUE
JEFFERSON CITY, MO 65105-2800

PRSRT STD
U.S. POSTAGE
PAID
Missouri Dept.
of Revenue

Please place this label in the address area of your claim. Do not use this label if it is incorrect. ▶

MISSOURI

2009 MISSOURI PROPERTY TAX CREDIT CLAIM

FINAL CHECKLIST BEFORE MAILING YOUR CLAIM.

THE INSTRUCTIONS AND FORM ITSELF WILL LIST BACK-UP INFORMATION NEEDED.

DID YOU NEED TO ATTACH ANY OF THESE?

- MO-CRP
- RENT RECEIPTS/LANDLORD STATEMENT
- SSA-1099 OR RRB-1099
- 2009 **PAID** REAL ESTATE RECEIPTS/ PERSONAL PROPERTY TAX RECEIPTS
- DISABLED VETERAN DOCUMENTATION
- POWER OF ATTORNEY/FEDERAL FORM 1310/DEATH CERTIFICATE

PLEASE NOTE!

- The maximum income level for residents who own and occupy their home for the **entire year** is $30,000 (after any exemptions).
- The maximum income level for residents who rented or owned their home a portion of the year is $27,500 (after any exemptions).
- The exemption for married filing combined is $4,000 if you own and occupy your home the **entire year.** If you rent the exemption is $2,000.
- The maximum credit for residents who own and occupy their home is $1,100. If you rent the maximum credit is $750.
- If you rent from a facility that does not pay property taxes, you are not eligible for a Property Tax Credit.

Homestead Preservation Credit (HPC)

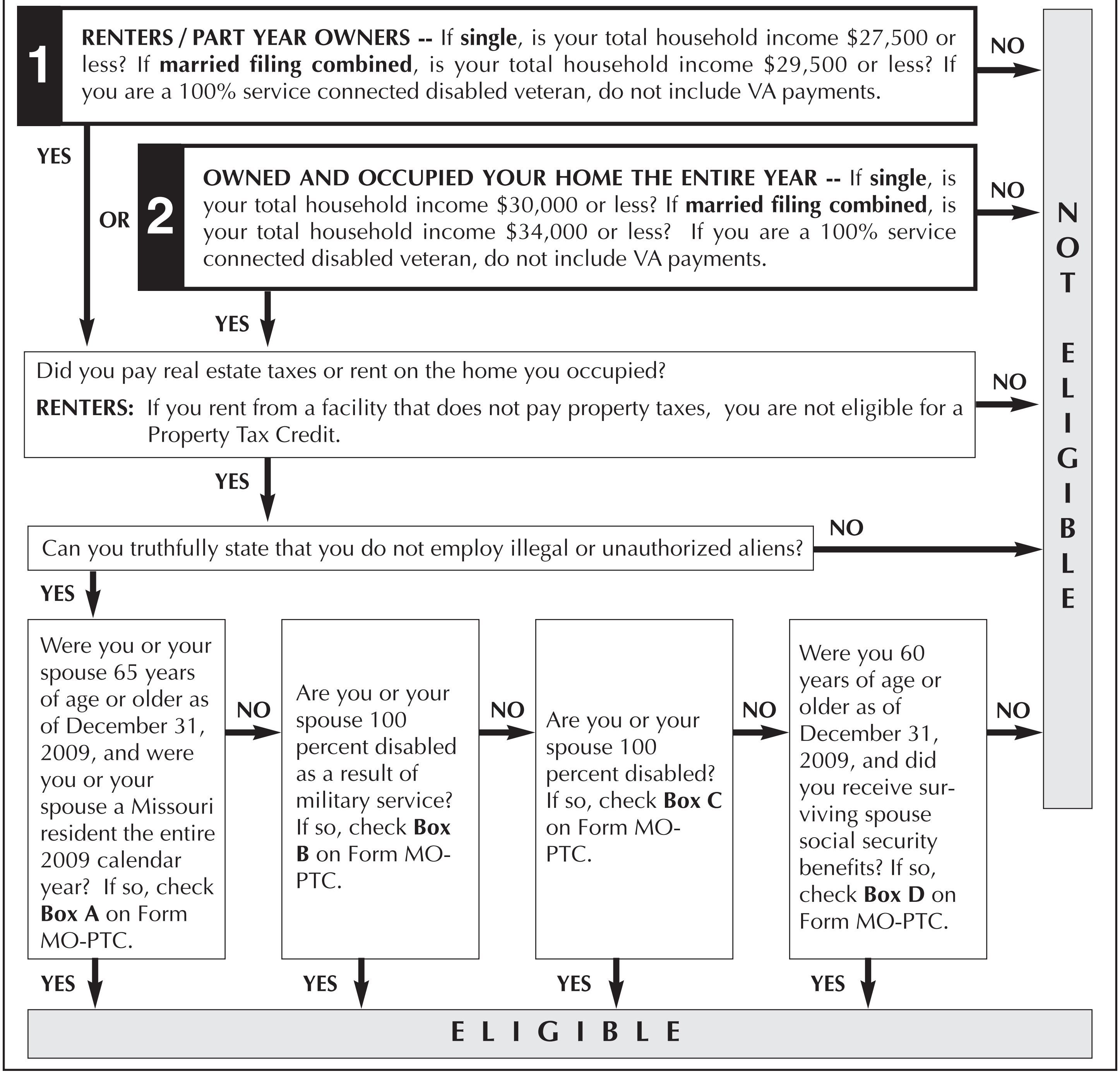
The department administers two real estate tax assistance programs for qualified senior citizens and 100 percent disabled individuals, the Missouri Property Tax Credit Claim (MO-PTC) and the Homestead Preservation Credit (HPC). If you own and occupy your home but your income restricts you from qualifying for the MO-PTC, you may be eligible for the HPC. You can only receive **ONE** of the credits. You should determine which tax credit program is more beneficial to you. For more information regarding the HPC, contact (573) 526-8942 or access **www.dor.mo.gov/tax/personal/homestead**.

AM I ELIGIBLE?

Use this diagram to determine if you or your spouse are eligible to claim the

PROPERTY TAX CREDIT

START DIAGRAM BY CHOOSING BOX 1 OR BOX 2 AND FOLLOW TO CONCLUSION.



This information is for guidance only and does not state complete law.

2-D Barcode Returns — If you plan on filing a paper return, you should consider 2-D barcode filing. The software encodes all your tax information into a 2-D barcode, which allows your return to be processed in a fraction of the time it takes to process a traditional paper return. If you use software to prepare your return, check our web site for approved 2-D barcode software companies. Also, check out the department's fill-in forms that calculate and have a 2-D barcode. **ALL** 2-D barcode returns should be mailed to: **Department of Revenue, P.O. Box 3385, Jefferson City, MO 65105-3385**.

What's Inside?

Am I Eligible? 2

Do I Have the Correct Tax Book? 3

Important Filing Information 3–4

Information to Complete Form MO-PTC . .4–8

Information to Complete Form MO-CRP . . .8

Form MO-PTC .9, 11

Form MO-CRP 10, 12

2009 Property Tax Credit Chart 13–15

Tax Assistance Centers 16

Do I Have the Correct Tax Book?

You **MAY USE** this tax book to file your 2009 Form MO-PTC, Property Tax Credit Claim if you meet the eligibility requirements on page 2 and are not required to file an individual income tax return.

You **cannot use this book** if you were required to file a federal return and you were a:

- Resident of Missouri and you had Missouri adjusted gross income of $1,200 or more;
- Nonresident of Missouri and had income of $600 or more from Missouri sources; or
- Resident or nonresident with Missouri withholding and you want to file an individual income tax return to claim a refund of your withholding.

If you meet any of the above qualifications, you **cannot** file the Form MO-PTC. You must file a Missouri income tax return and attach Form MO-PTS if you qualify for a property tax credit. See information in the next column to obtain the correct form (Form MO-1040 or Form MO-1040P) to file and claim your Property Tax Credit.

Exception: You are not required to file a Missouri income tax return if your standard deduction plus your personal exemption meet or exceed your Missouri adjusted gross income.

If you are a nonresident alien, access our web site at **www.dor.mo.gov/tax** for information.

Helpful Hint

If you anticipate receiving any 1099 or W-2 income, please wait to file this claim until all statements are received. Filing too early may result in a balance due.

To Obtain Forms

- Visit **www.dor.mo.gov/tax**
- Call the Forms-by-Fax System at (573) 751-4800 from your fax machine handset. The system will take you through the steps to fax a copy of the forms you need.

IMPORTANT FILING INFORMATION

This information is for guidance only and does not state the complete law.

When To File Claim

The 2009 Form MO-PTC is due April 15, 2010, but you may file up to three years from the due date and still receive your credit.

Where to Mail Claim

Mail your completed Form MO-PTC and all attachments to: **Department of Revenue**
P.O. Box 2800
Jefferson City, MO 65105-2800

Filing for Deceased Individuals

If an individual passed away in 2009, a claim may be filed by the surviving spouse if the filing status is "married filing combined" and all other qualifications are met. If there is no surviving spouse, the estate may file the claim.

A copy of the death certificate must be attached and if the check is to be issued in another name, a Federal Form 1310 must also accompany the claim. To obtain Federal Form 1310, access **www.irs.gov/formspubs.**

Any existing POA pending with the Department of Revenue is terminated when the death of the taxpayer is made known to the Department. A new POA (Form 2827) is required after death of the taxpayer before any party may discuss the taxpayer's debt with the Department staff.

Dollars and Cents

Rounding is required on your Form MO-PTC. Zeros have been placed in the cents column on your return. For 1 cent through 49 cents, round down to the previous whole dollar amount. For 50 cents through 99 cents, round up to the next whole dollar amount.

Example: Round $32.49 down to $32.00
Round $32.50 up to $33.00

Fill-in Forms that Calculate

Access our web site at **www.dor.mo.gov/tax** to enter your tax information, and let us do the math for you. No calculation errors means faster processing. Just print, sign, and mail the claim with required supporting documents.

Address Change

If you move after filing your return, notify both the post office serving your old address and the **Department of Revenue** of your address change. Address change requests should be mailed to: **Department of Revenue, P.O. Box 2200, Jefferson City, MO 65105-2200**. This will help forward any refund check or correspondence to your new address.

Missouri Return Inquiry

To check the status of your current year return 24 hours a day, please visit the department's web site: **www.dor.mo.gov/tax** or call our automated individual income tax inquiry line at (573)526-8299. To obtain the status of your return, you must know the following information: 1) the first social security number on the return; 2) the filing status shown on your return; and 3) the exact amount of the refund or balance due in whole dollars.

Taxpayer Bill of Rights

To obtain a copy of the Taxpayer Bill of Rights, you can access the department's web site at **www.dor.mo.gov/tax/personal/pubs.htm.**

FORM MO-PTC

Information to Complete Form MO-PTC

Name, Address, Etc.

If all the information on the label is correct, attach the label to the Form MO-PTC and print or type your social security number(s), birthdate(s), and telephone number in the spaces provided.

If you did not receive a book with a peel-off label or if the label is incorrect, print or type your name(s), address, social security number(s), birthdate(s), and telephone number in the spaces provided. If you or your spouse do not have a social security number, enter "none" in the appropriate space(s). If married, enter both birthdates, even if your spouse died during the calendar year. Only check the deceased box if death occurred in 2009. Do not check the box if the claimant was deceased before calendar year 2009.

Check the amended claim box if you are filing an amended claim. Complete the entire claim using the corrected figures.

Helpful Hints

- Please use the social security number of the person filing the claim.
- Do not use Form MO-PTC if you need to file an individual income tax return (Form MO-1040 or Form MO-1040P.) See page 3.

QUALIFICATIONS

Check the applicable box to indicate under which qualification you are filing the Form MO-PTC. See the "Am I Eligible" chart on page 2. You must check a qualification box to be eligible for the credit. Check **only** one box. **Attach the appropriate documentation to verify your qualification.** (The required documentation is listed behind each qualification on Form MO-PTC.)

FILING STATUS

Check your filing status. You can check "married — living separate for entire year" **only if you and your spouse did not at any time during the year live in the same residence.**

Note: If you lived at different addresses for the entire year, you may file a separate claim. You cannot take the $2,000 or $4,000 deduction on Line 7 if you checked "married-living separate for entire year," as your filing status, and you are filing a separate claim. (Example: One spouse lives in a nursing or residential care facility while the other spouse remains in the home the entire year.)

Helpful Hint

If you are legally married and lived together at any time during the year, you must file married filing combined and include all household income.

HOUSEHOLD INCOME

Household income is **all income** received by a claimant, spouse, and/or minor children (**taxable** or **nontaxable**) and includes all income from sources listed on Lines 1 through 5 of Form MO-PTC.

LINE 1 — SOCIAL SECURITY BENEFITS

Enter the amount of social security benefits received by you and/or your minor children before any deductions and/or amount of social security equivalent railroad retirement benefits. **Attach a copy of Form SSA-1099(s) and/or Form RRB-1099(s).**

Lump sum distributions must be claimed in the year in which they were received.

FORM SSA-1099 – SOCIAL SECURITY BENEFIT STATEMENT

2009
- PART OF YOUR SOCIAL SECURITY BENEFITS SHOWN IN BOX 5 MAY BE TAXABLE INCOME.
- SEE THE REVERSE SIDE FOR MORE INFORMATION.

Box 1. Name	Box 2. Beneficiary's Social Security Number
BETTY TAXPAYER	555-66-7777

Box 3. Benefits Paid in 2009	Box 4. Benefits Repaid to SSA in 2009	Box 5. Net Benefits for 2009 *(Box 3 minus Box 4)*
*$8,400.00	NONE	$8,400.00

DESCRIPTION OF AMOUNT IN BOX 3

Paid by check or direct deposit	$7,800.00
Medicare premiums deducted from your benefit	$600.00
Total Additions	$8,400.00
Benefits for 2009	$8,400.00

*Includes: $12.00 Paid in 2009 for 2008

DESCRIPTION OF AMOUNT IN BOX 4

NONE

Box 6. Voluntary Federal Income Tax Withheld

NONE

Box 7. Address

BETTY TAXPAYER
5500 TAXES LANE
TAXTOWN, MO 55555-5555

Box 8. Claim Number *(Use this number if you need to contact SSA.)*

555-66-7777

Form **SSA-1099-SM** (11-2009) **DO NOT RETURN THIS FORM TO SSA OR IRS** 0603554

Helpful Hints

- Wait to file your claim until you get your SSA-1099. This is not the statement indicating what your benefits will be, but it is the actual Form SSA-1099 received in January, 2010 that states what your benefits were for the entire 2009 year. See diagram on this page.
- If you are receiving railroad retirement benefits, you should receive two Form RRB-1099s. One Form RRB-1099-R shows annuities and pensions and the other is your social security equivalent railroad retirement benefits. Include the amount from Form RRB-1099 that states social security equivalent (usually Tier I benefits) on Line 1.

LINE 2 — WAGES, PENSIONS, ANNUITIES, DIVIDENDS, INTEREST, RENTAL INCOME, OR OTHER INCOME

Include the amount of **all** wages, pensions, annuities, dividends, interest income, rental income, or other income. Do not include excludable costs of pensions or annuities. (These are usually the employee's contribution to a retirement program listed separately on Form 1099-R.) **Attach Forms W-2(s), 1099(s), 1099-R(s), 1099-DIV, 1099-INT, 1099-MISC, etc.** If grants or long-term care benefits are made payable to the nursing facility, do not include as income or rent. If you have **any** negative income, you cannot use this form.

LINE 3 — RAILROAD RETIREMENT BENEFITS

Enter the gross distribution amount of railroad retirement benefits (not included in Line 1) before any deductions. This is the amount of annuities and pensions received, **not** your social security equivalent benefits. **Attach Form RRB/1099-R (Tier II).**

LINE 4 — VETERAN BENEFITS

Include your veteran payments and benefits. Veteran payments and benefits include education or training allowances, disability compensation, grants, and insurance proceeds.

Exceptions: If you are 100 percent disabled as a result of military service, you are not required to include your veteran payments and benefits. **You must attach a letter from the Veterans Administration that states you are 100 percent disabled as a result of military service.** To request a copy of the letter call the Veterans Administration at (800) 827-1000.

If you are a surviving spouse and your spouse was 100 percent disabled as a result of military service, all the veteran payments and benefits must be included.

LINE 5 — PUBLIC ASSISTANCE

Include the amount of public assistance, supplemental security income (SSI), child support, unemployment compensation, and Temporary Assistance payments received by you and/or your minor children. Temporary Assistance payments include Temporary Assistance for Needy Families (TANF) payments. In Missouri, the program is referred to as Temporary Assistance (TA). This includes any governmental cash received. Do not include the value of commodity foods, food stamps, or heating and cooling assistance.

Attach a copy of Form SSA-1099(s), a letter from the Social Security Administration and/or Social Services that includes the total amount of assistance received and Employment Security 1099, if applicable.

Helpful Hints

- Supplemental security income (SSI) is paid by the Social Security Administration. You have to request an SSI form indicating total benefits received from your local social security office. The form should be stamped or signed by the Social Security Administration. **If you have minor children who receive SSI benefits, the children do not qualify for a credit.** However, if you qualify for a credit you **must** include the children's SSI benefits on Line 5.
- If you receive temporary assistance from the Children's Division (CD) or the Family Support Division (FSD), you must include **all** cash benefits received for your **entire** household. The Department of Revenue verifies this information and failure to include total benefits may delay your refund.

LINE 7 — FILING STATUS DEDUCTION

Use your filing status to determine the deduction amount that will be entered on Line 7. If your filing status is **Single or Married Living Separate**, you will enter $0 on Line 7.

If your filing status is **Married and Filing Combined**, see below to determine the amount you will enter on Line 7.

- If you OWNED and OCCUPIED your home for the **ENTIRE YEAR**, enter $4,000 on Line 7.
- If you RENTED or **did not** own your home for the **ENTIRE YEAR**, enter $2,000 on Line 7.

LINE 8 — NET HOUSEHOLD INCOME

Subtract Line 7 from Line 6 and enter amount on Line 8. See below to make sure you are eligible for the credit.

- If you OWNED AND OCCUPIED your home for the **ENTIRE YEAR**, the amount you enter on Line 8 cannot exceed $30,000. If the amount of your net household income on Line 8 is above $30,000, you are not eligible for the credit.
- If you RENTED or did not own and occupy your home for the **ENTIRE YEAR**, the amount you enter on Line 8 cannot exceed $27,500. If the amount of your net household income on Line 8 is above $27,500, and you are not eligible for the credit.

LINE 9 — OWN YOUR HOME

If you owned and occupied your home, include the amount of real estate tax you paid. **Do not include special assessments (sewer lateral), penalties, service charges, and interest listed on your tax receipt.** You can only claim the taxes on your **primary** residence that you occupy. Secondary homes don't apply.

If you submit more than one receipt for a city or county for your residence, please submit a letter of explanation.

Your home or dwelling is the place in which you reside in Missouri, whether owned or rented, and the surrounding land, not to exceed five acres, as is reasonably necessary for use of the dwelling as a home. A home may be part of a larger unit such as a farm or building partly rented or used for business. It may be a room in a nursing home, an apartment, or a mobile home unit. If you share a home, report only the portion of real estate tax that was actually paid by you. If you sold or bought your home during the year, attach a copy of the seller's/buyer's agreement to your claim.

Helpful Hint

Real estate tax paid for a **prior year cannot** be claimed on this form. To claim real estate taxes for a prior year, you must file a claim for that year.

If your home or farm has more than five acres or you own a mobile home and it is classified as personal property, a Form 948 Assessors Certification must be attached with a copy of your paid personal/real property tax receipt. If you own a mobile home and it is classified as real property, a Form 948 isn't needed. If you own a mobile home for the entire year and also pay lot rent, you can claim credit for the property taxes and lot rent paid. The maximum combined credit is $1,100. A credit **will not** be allowed for vehicles listed on the personal property tax receipt.

Helpful Hint

The percentage of your home that is used for business purposes must be subtracted from your real estate taxes paid. If you need to use a Form 948 to calculate the amount of real estate tax, you must subtract the percentage of your home that is used for business purposes from the allowable real estate taxes paid calculated on the Form 948.

Example: Ruth has 10 acres surrounding her house. She needs to use a Form 948, because she is only entitled to receive credit for 5 acres. By her calculations, she enters $500 on Form 948, Line 6. Ruth also uses 15% of her house for her business. She will multiply $500 by 85% and put this figure ($425) on Form MO-PTC, Line 9.

Helpful Hint

If you own your home and other adults (other than your spouse) live there and pay rent, the rent **must** be claimed as income.

LINE 10 — RENT YOUR HOME

Complete one Form MO-CRP, Certification of Rent Paid, for **each** rented home (including mobile home and/or lot) you occupied during 2009. The Form MO-CRP is on the back of the Form MO-PTC and instructions are on page 8.

Add the totals from Line 9 on all Form MO-CRP(s) completed and enter the amount on Line 10.
Attach rent receipt(s) for the whole year or each month or a signed statement from your landlord, along with Form MO-CRP. Copies of cancelled checks (front and back) will be accepted if your landlord will not provide rent receipts or statement.

You cannot claim returned check fees, late fees, security and cleaning deposits, or any other deposit.

If you rent from a facility that does not pay property taxes, you are not eligible for a Property Tax Credit.

Helpful Hints

- If your rent is more than 60 percent of your income, you may be claiming the portion of your rent paid by a housing assistance program. Please claim only the amount of rent **you** pay or your refund will be delayed or denied. If you do not qualify for housing assistance, please send an explanation of how additional rent is being paid.
- If your gross rent paid exceeds your household income, you must attach a detailed statement explaining how the additional rent was paid or the claim will be denied.
- Utilities (air conditioning, gas, electric, late fees, deposits, etc.) are not included.
- Nursing Homes — You must deduct personal allowances (clothing, hair stylists, etc.) prior to calculating your rent.

LINE 11 — TOTAL REAL ESTATE TAX/RENT PAID

Add amounts from Form MO-PTC, Lines 9 and 10 and enter amount on Line 11.

You can claim the amount of your real estate tax if you:

- owned your home/mobile home;
- owned your home for part of the year and rented for part of the year;
- owned/rented a mobile home and pad;

The maximum amount allowed is $1,100. If you rented, the maximum amount allowed is $750.

Helpful Hints

An apartment is a room or suite of rooms with separate facilities for cooking and other normal household functions.

A boarding home is a house that provides meals, lodging, and the residents share common facilities.

CREDITS

LINE 12 — PROPERTY TAX CREDIT

Apply amounts from Form MO-PTC, Lines 8 and 11 to the Property Tax Credit Chart on pages 13 through 15 to determine the amount of your property tax credit. See Helpful Hint below.

If you have another income tax or property tax credit liability, this property tax credit may be applied to that liability in accordance with Section 143.782, RSMo. You will be notified if your credit is offset against any debts.

Helpful Hint

Your property tax credit is figured by comparing your total income received to 20 percent of your net rent paid or real estate tax paid. To make the comparison and determine your credit, use the 2009 Property Tax Credit Chart on pages 13 through 15. Lines are provided on the chart to help you figure this amount.

Example: Ruth paid $1,200 in real estate tax and her total household income was $15,000. Ruth will apply her tax paid and her total household income to the chart to figure out her credit amount. Even though Ruth paid $1,200 in real estate tax, she is only allowed to take a credit of $1,100. Ruth will use $1,100 as tax paid and her total household income of $15,000 to make the comparison. When using the chart, Ruth finds where $15,000 and $1,100 “meet” to figure her credit. The two numbers “meet” on the chart where the credit amount is $1,059. Ruth will get a $1,059 credit for the real estate tax she paid.

SIGN CLAIM

You must sign your Form MO-PTC. Both spouses must sign a combined claim. If you use a paid preparer, the preparer must also sign the claim.

If you wish to authorize the Director of Revenue, or delegate, to discuss your tax information with your preparer or any member of your preparer's firm, indicate "yes" by checking the appropriate box.

Important: If the Form MO-PTC is being filed on behalf of a claimant by a nursing home or residential care facility, a statement to that effect from the claimant's legal guardian or power of attorney must be attached to the Form MO-PTC.

MAIL CLAIM

Send your claim and all attachments to: **Department of Revenue, P.O. Box 2800, Jefferson City, MO 65105-2800.**

FAILURE TO INCLUDE REQUIRED DOCUMENTATION AND/OR INFORMATION MAY REDUCE OR DELAY YOUR REFUND.

INFORMATION TO COMPLETE FORM MO-CRP

STEP 1

Enter all information requested on Lines 1–5. If rent is paid to a relative, the relationship to the landlord must be indicated on Line 1. **Your claim may be delayed if you fail to enter all required information.**

STEP 2

Enter on Line 6 the gross rent paid. Exclude rent paid for any portion of your home used in the production of income, and the rent paid for surrounding land with attachments not necessary nor maintained for homestead purposes. **Also, exclude any rent paid to your landlord on your behalf by any organization or agency.**

STEP 3

If you were a resident of a nursing home or boarding home during 2009, use the applicable percentage in Line 7. If you live in a hotel and meals are included in your rent payment, enter 50 percent; otherwise enter 100 percent. If two or more unmarried individuals over 18 years of age share a residence and each pay part of the rent, enter the total rent on Form MO-CRP, Line 6 and mark the appropriate percentage on box G of Line 7. If the rent receipt is for the total rent amount, then the percentage on box G of the Form MO-CRP must be used to determine your credit. **Additional** persons sharing rent/percentage to be entered: (1 person—50%, 2 people—33%, 3 people —25%). If none of the reductions apply to you, enter 100 percent on Line 7.

STEP 4

Multiply Line 6 by the percentage on Line 7. Enter this amount on Form MO-CRP, Line 8.

STEP 5

Multiply Line 8 by 20% and enter the result on Line 9. Add the totals from Line 9 on **all** completed Form MO-CRP(s) and enter the amount on Line 10 of MO-PTC.

If you need to file an income tax return, Form MO-1040 or Form MO-1040P, you must use Form MO-PTS to claim a property tax credit and attach it to the Form MO-1040 or Form MO-1040P.

Do not use Form MO-PTC if you need to file an income tax return.

MISSOURI DEPARTMENT OF REVENUE

PROPERTY TAX CREDIT CLAIM

2009 FORM **MO-PTC**

NAME / ADDRESS

LAST NAME	FIRST NAME	INITIAL	**BIRTHDATE** __ / __ / ____	DECEASED 2009 ☐	SOCIAL SECURITY NO.	SOFTWARE VENDOR CODE (Assigned by DOR) **000**
SPOUSE'S **LAST NAME**	FIRST NAME	INITIAL	**BIRTHDATE** __ / __ / ____	DECEASED 2009 ☐	SPOUSE'S SOCIAL SECURITY NO.	
IN CARE OF NAME (ATTORNEY, EXECUTOR, PERSONAL REPRESENTATIVE, ETC.)			TELEPHONE NUMBER (___) ___ - ____			**AMENDED CLAIM** ☐
PRESENT HOME ADDRESS	APT. NUMBER		CITY, TOWN, OR POST OFFICE, STATE, AND ZIP CODE			

PLACE LABEL IN BLOCK

QUALIFICATIONS

You must check a qualification to be eligible for a credit. Check only one. Required copies of letters, forms, etc., must be included with claim.

- ☐ A. 65 years of age or older **(Attach a copy of Form SSA-1099.)**
- ☐ B. 100% Disabled Veteran as a result of military service **(Attach a copy of the letter from Department of Veterans Affairs.)**
- ☐ C. 100% Disabled **(Attach a copy of the letter from Social Security Administration or Form SSA-1099.)**
- ☐ D. 60 years of age or older and received surviving spouse benefits **(Attach a copy of Form SSA-1099.)**

FILING STATUS ☐ Single ☐ Married — Filing Combined ☐ Married — **Living Separate for Entire Year** — **If married filing combined, you must report both incomes.**

Failure to provide the attachments listed below (rent receipt(s), tax receipt(s),1099(s), W-2(s), etc.) will result in denial or delay of your claim!

HOUSEHOLD INCOME

1. Enter the amount of social security benefits received by you and/or your minor children before any deductions and/or the amount of social security equivalent railroad retirement benefits. **Attach Form SSA-1099 and/or RRB-1099.**	1	00
2. Enter the total amount of wages, pensions, annuities, dividends, interest income, rental income, or other income. **Attach Forms W-2(s), 1099(s), 1099-R(s), 1099-DIV, 1099-INT, 1099-MISC, etc.**	2	00
3. Enter the amount of railroad retirement benefits (not included in Line 1) before any deductions. **Attach Form RRB/1099-R (Tier II).**	3	00
4. Enter the amount of veteran's payments or benefits before any deductions. **Attach letter from Veterans Affairs.**	4	00
5. Enter the total amount received by you and/or your **minor children** from: public assistance, SSI, child support, Temporary Assistance payments (TA and/or TANF). **Attach a copy of Form SSA-1099(s), a letter from the Social Security Administration and/or Social Services that includes the total amount of assistance received and Employment Security 1099, if applicable.**	5	00
6. **TOTAL** household income — Add Lines 1 through 5.	6	00
7. Mark the box that applies and enter the appropriate amount. ☐ a. Enter $0 if filing status is Single or Married Living Separate; **If married and filing combined;** ☐ b. Enter $2,000 if you rented or did not own your home for the entire year; ☐ c. Enter $4,000 if you owned and occupied your home for the entire year;	7	- 00
8. Net household income — Subtract Line 7 from Line 6; and enter the amount; mark the box that applies. ☐ a. **If you rented or did not own and occupy your home for the entire year**, Line 8 cannot exceed $27,500. If the total is greater than $27,500, **STOP - no credit is allowed. Do not file this claim.** ☐ b. **If you owned and occupied your home for the entire year**, Line 8 cannot exceed $30,000. If the total is greater than $30,000, **STOP - no credit is allowed. Do not file this claim.**	8	00

REAL ESTATE TAX / RENT PAID

9. If you owned your home, enter the total amount of property tax paid for your home less special assessments. **Attach a copy of PAID real estate tax receipt(s). If your home is on more than five acres or you own a mobile home, attach Form 948, Assessor's Certification.**	9	00
10. If you rented, enter amount from Form MO-CRP(s), Line 9. **Attach rent receipt(s) for the whole year or each month or a statement from your landlord, along with Form MO-CRP. Copies of cancelled checks (front and back) will be accepted if your landlord will not provide rent receipts or statement. NOTE: If you rent from a facility that does not pay property taxes, you are not eligible for a Property Tax Credit.**	10	00
11. Add Lines 9 and 10. If you rented your home, enter the total or $750, whichever is less. If you owned your home, enter the total or $1,100, whichever is less.	11	00

CREDITS

12. You **must use the chart on pages 13-15** to see how much refund you are allowed. Apply amounts from Lines 8 and 11 to chart on pages 13-15 to figure your Property Tax Credit. Note: Renters - maximum allowed is $750. Owners - maximum amount allowed is $1,100.	12	00

SIGNATURE

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which he/she has any knowledge. As provided in Chapter 143, RSMo, a penalty of up to $500 shall be imposed on any individual who files a frivolous return. I also declare under penalties of perjury that I employ no illegal or unauthorized aliens as defined under federal law and that I am not eligible for any tax exemption, credit or abatement if I employ such aliens.

I authorize the Director of Revenue or delegate to discuss my claim and attachments with the preparer or any member of the preparer's firm. ☐ YES ☐ NO	E-MAIL ADDRESS		PREPARER'S PHONE (___) ___-____
SIGNATURE	DATE	PREPARER'S SIGNATURE	FEIN, SSN, OR PTIN
SPOUSE'S SIGNATURE	DAYTIME TELEPHONE (___) ___-____	PREPARER'S ADDRESS AND ZIP CODE	DATE

Mail claim and attachments to Missouri Department of Revenue, P.O. Box 2800, Jefferson City, MO 65105-2800.

For Privacy Notice, see the instructions.

MISSOURI DEPARTMENT OF REVENUE

CERTIFICATION OF RENT PAID FOR 2009

2009 FORM **MO-CRP**

Failure to provide landlord information will result in denial or delay of your claim.

1. SOCIAL SECURITY NUMBER

SPOUSE'S SOCIAL SECURITY NUMBER

ARE YOU RELATED TO YOUR LANDLORD? ☐ YES ☐ NO
IF YES, EXPLAIN.

2. NAME

3. LANDLORD'S NAME, LAST 4 DIGITS OF SSN, OR FEIN **(MUST BE COMPLETED)**

PHYSICAL ADDRESS OF RENTAL UNIT **(P.O. BOX NOT ALLOWED)** | APT. NUMBER

LANDLORD'S ADDRESS, CITY, STATE, AND ZIP CODE **(MUST BE COMPLETED)** | APT. NUMBER

CITY, STATE, AND ZIP CODE

4. LANDLORD'S PHONE NUMBER **(MUST BE COMPLETED)**
(__ __ __) __ __ __ - __ __ __ __

5. RENTAL PERIOD DURING YEAR — FROM: MONTH — DAY — YEAR **2009** TO: MONTH — DAY — YEAR **2009**

6. Enter your gross rent paid. **Attach rent receipt(s) for each rent payment for the entire year, a statement from your landlord, or copies of cancelled checks (front and back). If receiving housing assistance, enter the amount of rent YOU paid.** . . . 6 | .00
NOTE: If you rent from a facility that does not pay property taxes, you are not eligible for a Property Tax Credit.

7. Check the appropriate box and enter the corresponding percentage on Line 7.
- ☐ A. APARTMENT, HOUSE, MOBILE HOME, OR DUPLEX — **100%**
- ☐ B. MOBILE HOME LOT — **100%**
- ☐ C. BOARDING HOME / RESIDENTIAL CARE — **50%**
- ☐ D. SKILLED OR INTERMEDIATE CARE NURSING HOME — **45%**
- ☐ E. HOTEL If meals are included, enter — **50%;** Otherwise, enter — **100%**
- ☐ F. LOW INCOME HOUSING — **100%** **(Rent cannot exceed 40% of total household income.)**
- ☐ G. SHARED RESIDENCE — If you shared your rent with relatives and/or friends **(other than your spouse or children under 18)**, check the appropriate box and enter percentage.
  Additional **persons sharing rent/percentage to be entered:** ☐ 1 (50%) ☐ 2 (33%) ☐ 3 (25%) . . . . . 7 | %

8. Net rent paid — Multiply Line 6 by the percentage on Line 7. . . . . 8 | .00

9. Multiply Line 8 by 20%. Enter amount here and on Line 10 of Form MO-PTC or Line 12 of Form MO-PTS. . . . . 9 | .00

MO 860-1089 (02-2010)

For Privacy Notice, see the instructions.

MISSOURI DEPARTMENT OF REVENUE

CERTIFICATION OF RENT PAID FOR 2009

2009 FORM **MO-CRP**

Failure to provide landlord information will result in denial or delay of your claim.

1. SOCIAL SECURITY NUMBER

SPOUSE'S SOCIAL SECURITY NUMBER

ARE YOU RELATED TO YOUR LANDLORD? ☐ YES ☐ NO
IF YES, EXPLAIN.

2. NAME

3. LANDLORD'S NAME, LAST 4 DIGITS OF SSN, OR FEIN **(MUST BE COMPLETED)**

PHYSICAL ADDRESS OF RENTAL UNIT **(P.O. BOX NOT ALLOWED)** | APT. NUMBER

LANDLORD'S ADDRESS, CITY, STATE, AND ZIP CODE **(MUST BE COMPLETED)** | APT. NUMBER

CITY, STATE, AND ZIP CODE

4. LANDLORD'S PHONE NUMBER **(MUST BE COMPLETED)**
(__ __ __) __ __ __ - __ __ __ __

5. RENTAL PERIOD DURING YEAR — FROM: MONTH — DAY — YEAR **2009** TO: MONTH — DAY — YEAR **2009**

6. Enter your gross rent paid. **Attach rent receipt(s) for each rent payment for the entire year, a statement from your landlord, or copies of cancelled checks (front and back). If receiving housing assistance, enter the amount of rent YOU paid.** . . . 6 | .00
NOTE: If you rent from a facility that does not pay property taxes, you are not eligible for a Property Tax Credit.

7. Check the appropriate box and enter the corresponding percentage on Line 7.
- ☐ A. APARTMENT, HOUSE, MOBILE HOME, OR DUPLEX — **100%**
- ☐ B. MOBILE HOME LOT — **100%**
- ☐ C. BOARDING HOME / RESIDENTIAL CARE — **50%**
- ☐ D. SKILLED OR INTERMEDIATE CARE NURSING HOME — **45%**
- ☐ E. HOTEL If meals are included, enter — **50%;** Otherwise, enter — **100%**
- ☐ F. LOW INCOME HOUSING — **100%** **(Rent cannot exceed 40% of total household income.)**
- ☐ G. SHARED RESIDENCE — If you shared your rent with relatives and/or friends **(other than your spouse or children under 18)**, check the appropriate box and enter percentage.
  Additional **persons sharing rent/percentage to be entered:** ☐ 1 (50%) ☐ 2 (33%) ☐ 3 (25%) . . . . . 7 | %

8. Net rent paid — Multiply Line 6 by the percentage on Line 7. . . . . 8 | .00

9. Multiply Line 8 by 20%. Enter amount here and on Line 10 of Form MO-PTC or Line 12 of Form MO-PTS. . . . . 9 | .00

MO 860-1089 (02-2010)

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MISSOURI DEPARTMENT OF REVENUE

PROPERTY TAX CREDIT CLAIM

2009 FORM **MO-PTC**

NAME / ADDRESS

LAST NAME	FIRST NAME	INITIAL	BIRTHDATE	DECEASED 2009	SOCIAL SECURITY NO.	SOFTWARE VENDOR CODE (Assigned by DOR)
PLACE LABEL IN BLOCK			__ __ / __ __ / __ __ __ __	☐		000
SPOUSE'S LAST NAME	FIRST NAME	INITIAL	BIRTHDATE	DECEASED 2009	SPOUSE'S SOCIAL SECURITY NO.	
			__ __ / __ __ / __ __ __ __	☐		
IN CARE OF NAME (ATTORNEY, EXECUTOR, PERSONAL REPRESENTATIVE, ETC.)			TELEPHONE NUMBER (___ ___ ___) ___ ___ ___ – ___ ___ ___ ___			AMENDED CLAIM ☐
PRESENT HOME ADDRESS		APT. NUMBER	CITY, TOWN, OR POST OFFICE, STATE, AND ZIP CODE			

QUALIFICATIONS

You must check a qualification to be eligible for a credit. Check only one. Required copies of letters, forms, etc., must be included with claim.

☐ A. 65 years of age or older **(Attach a copy of Form SSA-1099.)**

☐ B. 100% Disabled Veteran as a result of military service **(Attach a copy of the letter from Department of Veterans Affairs.)**

☐ C. 100% Disabled **(Attach a copy of the letter from Social Security Administration or Form SSA-1099.)**

☐ D. 60 years of age or older and received surviving spouse benefits **(Attach a copy of Form SSA-1099.)**

FILING STATUS ☐ Single ☐ Married — Filing Combined ☐ Married — **Living Separate for Entire Year** — **If married filing combined, you must report both incomes.**

Failure to provide the attachments listed below (rent receipt(s), tax receipt(s),1099(s), W-2(s), etc.) will result in denial or delay of your claim!

HOUSEHOLD INCOME

1. Enter the amount of social security benefits received by you and/or your minor children before any deductions and/or the amount of social security equivalent railroad retirement benefits. **Attach Form SSA-1099 and/or RRB-1099.**	1	00
2. Enter the total amount of wages, pensions, annuities, dividends, interest income, rental income, or other income. **Attach Forms W-2(s), 1099(s), 1099-R(s), 1099-DIV, 1099-INT, 1099-MISC, etc.**	2	00
3. Enter the amount of railroad retirement benefits (not included in Line 1) before any deductions. **Attach Form RRB/1099-R (Tier II).**	3	00
4. Enter the amount of veteran's payments or benefits before any deductions. **Attach letter from Veterans Affairs.**	4	00
5. Enter the total amount received by you and/or your **minor children** from: public assistance, SSI, child support, Temporary Assistance payments (TA and/or TANF). **Attach a copy of Form SSA-1099(s), a letter from the Social Security Administration and/or Social Services that includes the total amount of assistance received and Employment Security 1099, if applicable.**	5	00
6. **TOTAL** household income — Add Lines 1 through 5.	6	00
7. Mark the box that applies and enter the appropriate amount. ☐ a. Enter $0 if filing status is Single or Married Living Separate; **If married and filing combined;** ☐ b. Enter $2,000 if you rented or did not own your home for the entire year; ☐ c. Enter $4,000 if you owned and occupied your home for the entire year;	7	- 00
8. Net household income — Subtract Line 7 from Line 6; and enter the amount; mark the box that applies. ☐ a. **If you rented or did not own and occupy your home for the entire year**, Line 8 cannot exceed $27,500. If the total is greater than $27,500, **STOP - no credit is allowed. Do not file this claim.** ☐ b. **If you owned and occupied your home for the entire year**, Line 8 cannot exceed $30,000. If the total is greater than $30,000, **STOP - no credit is allowed. Do not file this claim.**	8	00

REAL ESTATE TAX / RENT PAID

9. If you owned your home, enter the total amount of property tax paid for your home less special assessments. **Attach a copy of PAID real estate tax receipt(s). If your home is on more than five acres or you own a mobile home, attach Form 948, Assessor's Certification.**	9	00
10. If you rented, enter amount from Form MO-CRP(s), Line 9. **Attach rent receipt(s) for the whole year or each month or a statement from your landlord, along with Form MO-CRP. Copies of cancelled checks (front and back) will be accepted if your landlord will not provide rent receipts or statement. NOTE: If you rent from a facility that does not pay property taxes, you are not eligible for a Property Tax Credit.**	10	00
11. Add Lines 9 and 10. If you rented your home, enter the total or $750, whichever is less. If you owned your home, enter the total or $1,100, whichever is less.	11	00

CREDITS

12. You **must use the chart on pages 13-15** to see how much refund you are allowed. Apply amounts from Lines 8 and 11 to chart on pages 13-15 to figure your Property Tax Credit. Note: Renters - maximum allowed is $750. Owners - maximum amount allowed is $1,100.	12	00

SIGNATURE

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which he/she has any knowledge. As provided in Chapter 143, RSMo, a penalty of up to $500 shall be imposed on any individual who files a frivolous return. I also declare under penalties of perjury that I employ no illegal or unauthorized aliens as defined under federal law and that I am not eligible for any tax exemption, credit or abatement if I employ such aliens.

I authorize the Director of Revenue or delegate to discuss my claim and attachments with the preparer or any member of the preparer's firm. ☐ YES ☐ NO	E-MAIL ADDRESS		PREPARER'S PHONE (___ ___ ___) ___ ___ ___- ___ ___ ___ ___
SIGNATURE	DATE	PREPARER'S SIGNATURE	FEIN, SSN, OR PTIN
SPOUSE'S SIGNATURE	DAYTIME TELEPHONE (_ _ _) _ _ _- _ _ _ _	PREPARER'S ADDRESS AND ZIP CODE	DATE

Mail claim and attachments to Missouri Department of Revenue, P.O. Box 2800, Jefferson City, MO 65105-2800.

For Privacy Notice, see the instructions.

MISSOURI DEPARTMENT OF REVENUE
CERTIFICATION OF RENT PAID FOR 2009

2009 FORM **MO-CRP**

Failure to provide landlord information will result in denial or delay of your claim.

1. SOCIAL SECURITY NUMBER | SPOUSE'S SOCIAL SECURITY NUMBER | ARE YOU RELATED TO YOUR LANDLORD? ☐ YES ☐ NO IF YES, EXPLAIN.

2. NAME

3. LANDLORD'S NAME, LAST 4 DIGITS OF SSN, OR FEIN **(MUST BE COMPLETED)**

PHYSICAL ADDRESS OF RENTAL UNIT **(P.O. BOX NOT ALLOWED)** | APT. NUMBER

LANDLORD'S ADDRESS, CITY, STATE, AND ZIP CODE **(MUST BE COMPLETED)** | APT. NUMBER

CITY, STATE, AND ZIP CODE

4. LANDLORD'S PHONE NUMBER **(MUST BE COMPLETED)** (__ __ __) __ __ __ - __ __ __ __

5. RENTAL PERIOD DURING YEAR — FROM: MONTH — DAY — YEAR **2009** TO: MONTH — DAY — YEAR **2009**

6. Enter your gross rent paid. **Attach rent receipt(s) for each rent payment for the entire year, a statement from your landlord, or copies of cancelled checks (front and back). If receiving housing assistance, enter the amount of rent YOU paid.** . . . 6 | 00

NOTE: If you rent from a facility that does not pay property taxes, you are not eligible for a Property Tax Credit.

7. Check the appropriate box and enter the corresponding percentage on Line 7.
- ☐ A. APARTMENT, HOUSE, MOBILE HOME, OR DUPLEX — **100%**
- ☐ B. MOBILE HOME LOT — **100%**
- ☐ C. BOARDING HOME / RESIDENTIAL CARE — **50%**
- ☐ D. SKILLED OR INTERMEDIATE CARE NURSING HOME — **45%**
- ☐ E. HOTEL If meals are included, enter — **50%;** Otherwise, enter — **100%**
- ☐ F. LOW INCOME HOUSING — **100% (Rent cannot exceed 40% of total household income.)**
- ☐ G. SHARED RESIDENCE — If you shared your rent with relatives and/or friends **(other than your spouse or children under 18)**, check the appropriate box and enter percentage.

Additional **persons sharing rent/percentage to be entered:** ☐ 1 (50%) ☐ 2 (33%) ☐ 3 (25%) . . . . . 7 | %

8. Net rent paid — Multiply Line 6 by the percentage on Line 7. . . . . 8 | 00

9. Multiply Line 8 by 20%. Enter amount here and on Line 10 of Form MO-PTC or Line 12 of Form MO-PTS. . . . . 9 | 00

MO 860-1089 (02-2010)

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MISSOURI DEPARTMENT OF REVENUE
CERTIFICATION OF RENT PAID FOR 2009

2009 FORM MO-CRP

Failure to provide landlord information will result in denial or delay of your claim.

1. SOCIAL SECURITY NUMBER | SPOUSE'S SOCIAL SECURITY NUMBER | ARE YOU RELATED TO YOUR LANDLORD? ☐ YES ☐ NO IF YES, EXPLAIN.

2. NAME

3. LANDLORD'S NAME, LAST 4 DIGITS OF SSN, OR FEIN (MUST BE COMPLETED)

PHYSICAL ADDRESS OF RENTAL UNIT (P.O. BOX NOT ALLOWED) | APT. NUMBER

LANDLORD'S ADDRESS, CITY, STATE, AND ZIP CODE (MUST BE COMPLETED) | APT. NUMBER

CITY, STATE, AND ZIP CODE

4. LANDLORD'S PHONE NUMBER (MUST BE COMPLETED) (__ __ __) __ __ __ - __ __ __ __

5. RENTAL PERIOD DURING YEAR — FROM: MONTH — DAY — YEAR 2009 TO: MONTH — DAY — YEAR 2009

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7. Check the appropriate box and enter the corresponding percentage on Line 7.
- ☐ A. APARTMENT, HOUSE, MOBILE HOME, OR DUPLEX — 100%
- ☐ B. MOBILE HOME LOT — 100%
- ☐ C. BOARDING HOME / RESIDENTIAL CARE — 50%
- ☐ D. SKILLED OR INTERMEDIATE CARE NURSING HOME — 45%
- ☐ E. HOTEL If meals are included, enter — 50%; Otherwise, enter — 100%
- ☐ F. LOW INCOME HOUSING — 100% (Rent cannot exceed 40% of total household income.)
- ☐ G. SHARED RESIDENCE — If you shared your rent with relatives and/or friends (other than your spouse or children under 18), check the appropriate box and enter percentage.

Additional persons sharing rent/percentage to be entered: ☐ 1 (50%) ☐ 2 (33%) ☐ 3 (25%) . . . . . 7 | %

8. Net rent paid — Multiply Line 6 by the percentage on Line 7. . . . . 8 | 00

9. Multiply Line 8 by 20%. Enter amount here and on Line 10 of Form MO-PTC or Line 12 of Form MO-PTS. . . . . 9 | 00

MO 860-1089 (02-2010)

For Privacy Notice, see the instructions.

A. Enter amount from Line 8 here ____________________ B. Enter amount from Line 11 here ____________________

C. Find where these two numbers "meet" below to figure your credit amount. Enter on Form MO-PTC, Line 12.

2009 PROPERTY TAX CREDIT CHART

AMOUNT FROM LINE B ABOVE OR FROM FORM MO-PTC, LINE 11 — TOTAL REAL ESTATE TAX PAID

	FROM	1076	1051	1026	1001	976	951	926	901	876	851	826	801	776	751
	TO	1100	1075	1050	1025	1000	975	950	925	900	875	850	825	800	775
FROM	**TO**														
1	14,300	**Refund is the actual total amount of allowable real estate tax paid, not to exceed $1,100 or rent credit equivalent not to exceed $750 (Form MO-PTC, Line 11). NOTE: If you rent from a facility that does not pay property taxes, you are not eligible for a Property Tax Credit.**													
14,301	14,600	1078	1053	1028	1003	978	953	928	903	878	853	828	803	778	753
14,601	14,900	1069	1044	1019	994	969	944	919	894	869	844	819	794	769	744
14,901	15,200	1059	1034	1009	984	959	934	909	884	859	834	809	784	759	734
15,201	15,500	1049	1024	999	974	949	924	899	874	849	824	799	774	749	724
15,501	15,800	1039	1014	989	964	939	914	889	864	839	814	789	764	739	714
15,801	16,100	1028	1003	978	953	928	903	878	853	828	803	778	753	728	703
16,101	16,400	1016	991	966	941	916	891	866	841	816	791	766	741	716	691
16,401	16,700	1005	980	955	930	905	880	855	830	805	780	755	730	705	680
16,701	17,000	993	968	943	918	893	868	843	818	793	768	743	718	693	668
17,001	17,300	980	955	930	905	880	855	830	805	780	755	730	705	680	655
17,301	17,600	968	943	918	893	868	843	818	793	768	743	718	693	668	643
17,601	17,900	954	929	904	879	854	829	804	779	754	729	704	679	654	629
17,901	18,200	941	916	891	866	841	816	791	766	741	716	691	666	641	616
18,201	18,500	927	902	877	852	827	802	777	752	727	702	677	652	627	602
18,501	18,800	913	888	863	838	813	788	763	738	713	688	663	638	613	588
18,801	19,100	898	873	848	823	798	773	748	723	698	673	648	623	598	573
19,101	19,400	883	858	833	808	783	758	733	708	683	658	633	608	583	558
19,401	19,700	868	843	818	793	768	743	718	693	668	643	618	593	568	543
19,701	20,000	852	827	802	777	752	727	702	677	652	627	602	577	552	527
20,001	20,300	836	811	786	761	736	711	686	661	636	611	586	561	536	511
20,301	20,600	819	794	769	744	719	694	669	644	619	594	569	544	519	494
20,601	20,900	802	777	752	727	702	677	652	627	602	577	552	527	502	477
20,901	21,200	785	760	735	710	685	660	635	610	585	560	535	510	485	460
21,201	21,500	767	742	717	692	667	642	617	592	567	542	517	492	467	442
21,501	21,800	749	724	699	674	649	624	599	574	549	524	499	474	449	424
21,801	22,100	731	706	681	656	631	606	581	556	531	506	481	456	431	406
22,101	22,400	712	687	662	637	612	587	562	537	512	487	462	437	412	387
22,401	22,700	693	668	643	618	593	568	543	518	493	468	443	418	393	368
22,701	23,000	673	648	623	598	573	548	523	498	473	448	423	398	373	348
23,001	23,300	653	628	603	578	553	528	503	478	453	428	403	378	353	328
23,301	23,600	633	608	583	558	533	508	483	458	433	408	383	358	333	308
23,601	23,900	613	588	563	538	513	488	463	438	413	388	363	338	313	288
23,901	24,200	591	566	541	516	491	466	441	416	391	366	341	316	291	266
24,201	24,500	570	545	520	495	470	445	420	395	370	345	320	295	270	245
24,501	24,800	548	523	498	473	448	423	398	373	348	323	298	273	248	223
24,801	25,100	526	501	476	451	426	401	376	351	326	301	276	251	226	201
25,101	25,400	504	479	454	429	404	379	354	329	304	279	254	229	204	179
25,401	25,700	481	456	431	406	381	356	331	306	281	256	231	206	181	156
25,701	26,000	457	432	407	382	357	332	307	282	257	232	207	182	157	132
26,001	26,300	434	409	384	359	334	309	284	259	234	209	184	159	134	109
26,301	26,600	410	385	360	335	310	285	260	235	210	185	160	135	110	85
26,601	26,900	385	360	335	310	285	260	235	210	185	160	135	110	85	60
26,901	27,200	361	336	311	286	261	236	211	186	161	136	111	86	61	36
27,201	27,500	335	310	285	260	235	210	185	160	135	110	85	60	35	10
27,501	27,800	310	285	260	235	210	185	160	135	110	85	60	35	10	
27,801	28,100	284	259	234	209	184	159	134	109	84	59	34	9		
28,101	28,400	258	233	208	183	158	133	108	83	58	33	8			
28,401	28,700	231	206	181	156	131	106	81	56	31	6				
28,701	29,000	204	179	154	129	104	79	54	29	4					
29,001	29,300	177	152	127	102	77	52	27	2						
29,301	29,600	149	124	99	74	49	24								
29,601	29,900	121	96	71	46	21									
29,901	30,000	95	70	45	20										

A. Enter amount from Line 8 here ____________________ B. Enter amount from Line 11 here ____________________

C. Find where these two numbers “meet” below to figure your credit amount. Enter on Form MO-PTC, Line 12.

AMOUNT FROM LINE B ABOVE OR FROM FORM MO-PTC, LINE 11 — TOTAL REAL ESTATE TAX OR 20% OF RENT PAID.

	FROM	726	701	676	651	626	601	576	551	526	501	476	451	426	401
	TO	750	725	700	675	650	625	600	575	550	525	500	475	450	425
FROM	**TO**														
1	14,300	**Refund is the actual total amount of allowable real estate tax paid, not to exceed $1,100 or rent credit equivalent not to exceed $750 (Form MO-PTC, Line 11). NOTE: If you rent from a facility that does not pay property taxes, you are not eligible for a Property Tax Credit.**													
14,301	14,600	728	703	678	653	628	603	578	553	528	503	478	453	428	403
14,601	14,900	719	694	669	644	619	594	569	544	519	494	469	444	419	394
14,901	15,200	709	684	659	634	609	584	559	534	509	484	459	434	409	384
15,201	15,500	699	674	649	624	599	574	549	524	499	474	449	424	399	374
15,501	15,800	689	664	639	614	589	564	539	514	489	464	439	414	389	364
15,801	16,100	678	653	628	603	578	553	528	503	478	453	428	403	378	353
16,101	16,400	666	641	616	591	566	541	516	491	466	441	416	391	366	341
16,401	16,700	655	630	605	580	555	530	505	480	455	430	405	380	355	330
16,701	17,000	643	618	593	568	543	518	493	468	443	418	393	368	343	318
17,001	17,300	630	605	580	555	530	505	480	455	430	405	380	355	330	305
17,301	17,600	618	593	568	543	518	493	468	443	418	393	368	343	318	293
17,601	17,900	604	579	554	529	504	479	454	429	404	379	354	329	304	279
17,901	18,200	591	566	541	516	491	466	441	416	391	366	341	316	291	266
18,201	18,500	577	552	527	502	477	452	427	402	377	352	327	302	277	252
18,501	18,800	563	538	513	488	463	438	413	388	363	338	313	288	263	238
18,801	19,100	548	523	498	473	448	423	398	373	348	323	298	273	248	223
19,101	19,400	533	508	483	458	433	408	383	358	333	308	283	258	233	208
19,401	19,700	518	493	468	443	418	393	368	343	318	293	268	243	218	193
19,701	20,000	502	477	452	427	402	377	352	327	302	277	252	227	202	177
20,001	20,300	486	461	436	411	386	361	336	311	286	261	236	211	186	161
20,301	20,600	469	444	419	394	369	344	319	294	269	244	219	194	169	144
20,601	20,900	452	427	402	377	352	327	302	277	252	227	202	177	152	127
20,901	21,200	435	410	385	360	335	310	285	260	235	210	185	160	135	110
21,201	21,500	417	392	367	342	317	292	267	242	217	192	167	142	117	92
21,501	21,800	399	374	349	324	299	274	249	224	199	174	149	124	99	74
21,801	22,100	381	356	331	306	281	256	231	206	181	156	131	106	81	56
22,101	22,400	362	337	312	287	262	237	212	187	162	137	112	87	62	37
22,401	22,700	343	318	293	268	243	218	193	168	143	118	93	68	43	18
22,701	23,000	323	298	273	248	223	198	173	148	123	98	73	48	23	
23,001	23,300	303	278	253	228	203	178	153	128	103	78	53	28	3	
23,301	23,600	283	258	233	208	183	158	133	108	83	58	33	8		
23,601	23,900	263	238	213	188	163	138	113	88	63	38	13			
23,901	24,200	241	216	191	166	141	116	91	66	41	16				
24,201	24,500	220	195	170	145	120	95	70	45	20					
24,501	24,800	198	173	148	123	98	73	48	23						
24,801	25,100	176	151	126	101	76	51	26	1						
25,101	25,400	154	129	104	79	54	29	4							
25,401	25,700	131	106	81	56	31	6								
25,701	26,000	107	82	57	32	7									
26,001	26,300	84	59	34	9										
26,301	26,600	60	35	10											
26,601	26,900	35	10												
26,901	27,200	11													
27,201	27,500														
27,501	27,800														
27,801	28,100														
28,101	28,400														
28,401	28,700														
28,701	29,000														
29,001	29,300														
29,301	29,600														
29,601	29,900														
29,901	30,000														

EXAMPLE:
If Line 8 is $23,980 and Line 11 of Form MO-PTC is $525, then the tax credit would be $16.

A. Enter amount from Line 8 here ____________________ B. Enter amount from Line 11 here ____________________

C. Find where these two numbers "meet" below to figure your credit amount. Enter on Form MO-PTC, Line 12.

AMOUNT FROM LINE B ABOVE OR FROM FORM MO-PTC, LINE 11 — TOTAL REAL ESTATE TAX OR 20% OF RENT PAID.

FROM	TO	376 TO 400	351 TO 375	326 TO 350	301 TO 325	276 TO 300	251 TO 275	226 TO 250	201 TO 225	176 TO 200	151 TO 175	126 TO 150	101 TO 125	76 TO 100	51 TO 75	26 TO 50	1 TO 25
1	14,300	**Refund is the actual total amount of allowable real estate tax paid, not to exceed $1,100 or rent credit equivalent not to exceed $750 (Form MO-PTC, Line 11). NOTE: If you rent from a facility that does not pay property taxes, you are not eligible for a Property Tax Credit.**															
14,301	14,600	378	353	328	303	278	253	228	203	178	153	128	103	78	53	28	3
14,601	14,900	369	344	319	294	269	244	219	194	169	144	119	94	69	44	19	
14,901	15,200	359	334	309	284	259	234	209	184	159	134	109	84	59	34	9	
15,201	15,500	349	324	299	274	249	224	199	174	149	124	99	74	49	24		
15,501	15,800	339	314	289	264	239	214	189	164	139	114	89	64	39	14		
15,801	16,100	328	303	278	253	228	203	178	153	128	103	78	53	28	3		
16,101	16,400	316	291	266	241	216	191	166	141	116	91	66	41	16			
16,401	16,700	305	280	255	230	205	180	155	130	105	80	55	30	5			
16,701	17,000	293	268	243	218	193	168	143	118	93	68	43	18				
17,001	17,300	280	255	230	205	180	155	130	105	80	55	30	5				
17,301	17,600	268	243	218	193	168	143	118	93	68	43	18					
17,601	17,900	254	229	204	179	154	129	104	79	54	29	4					
17,901	18,200	241	216	191	166	141	116	91	66	41	16						
18,201	18,500	227	202	177	152	127	102	77	52	27	2						
18,501	18,800	213	188	163	138	113	88	63	38	13							
18,801	19,100	198	173	148	123	98	73	48	23								
19,101	19,400	183	158	133	108	83	58	33	8								
19,401	19,700	168	143	118	93	68	43	18									
19,701	20,000	152	127	102	77	52	27	2									
20,001	20,300	136	111	86	61	36	11										
20,301	20,600	119	94	69	44	19											
20,601	20,900	102	77	52	27	2											
20,901	21,200	85	60	35	10												
21,201	21,500	67	42	17													
21,501	21,800	49	24														
21,801	22,100	31	6														
22,101	22,400	12															
22,401	22,700																
22,701	23,000																
23,001	23,300																
23,301	23,600																
23,601	23,900																
23,901	24,200																
24,201	24,500																
24,501	24,800																
24,801	25,100																
25,101	25,400																
25,401	25,700																
25,701	26,000																
26,001	26,300																
26,301	26,600																
26,601	26,900																
26,901	27,200																
27,201	27,500																
27,501	27,800																
27,801	28,100																
28,101	28,400																
28,401	28,700																
28,701	29,000																
29,001	29,300																
29,301	29,600																
29,601	29,900																
29,901	30,000																

This area indicates no credit is allowable.

EXAMPLE:
If Line 8 is $19,360 and Line 11 of Form MO-PTC is $225, then the tax credit would be $8.

Missouri Department of Revenue Tax Assistance Centers

Public hours Monday through Friday at the offices listed below are:

January through April	May through December
7:30 a.m. to 5:30 p.m.	8:00 a.m. to 5:00 p.m.

Individuals with speech or hearing impairments may use TDD(800) 735-2966 or fax (573) 526-1881.

Cape Girardeau
3102 Blattner Dr., Suite 102
(573) 290-5850

Jefferson City
301 W. High, Room 330
(573) 751-7191

Joplin
1110 East 7th St., Suite 400
(417) 629-3070

Kansas City
615 East 13th St., Room 127
(816) 889-2920

Springfield
149 Park Central Square, Room 313
(417) 895-6474

St. Louis
3256 Laclede Station Rd., Suite 101
(314) 877-0177

St. Joseph
525 Jules, Room 314
(816) 387-2230

Other Important Phone Numbers

Forms-by-Fax	(573) 751-4800
Automated IVR Refund/Balance Due Inquiry	(573) 526-8299
Electronic Filing Information	(573) 751-3930
General Inquiry Line	(573) 526-8942

Download forms or check the status of your refund from our web site

www.dor.mo.gov/tax

Suggestions for Improvements to Forms and Instructions e-mail: **taxsuggest@dor.mo.gov**

Property Tax Credit e-mail: **propertytaxcredit@dor.mo.gov**

Federal Privacy Notice

The Federal Privacy Act requires the Missouri Department of Revenue (Department) to inform taxpayers of the Department's legal authority for requesting identifying information, including social security numbers, and to explain why the information is needed and how the information will be used.

Chapter 143 of the Missouri Revised Statutes authorizes the Department to request information necessary to carry out the tax laws of the state of Missouri. Federal law 42 U.S.C. Section 405 (c)(2)(C) authorizes the states to require taxpayers to provide social security numbers.

The Department uses your social security number to identify you and process your tax returns and other documents, to determine and collect the correct amount of tax, to ensure you are complying with the tax laws, and to exchange tax information with the Internal Revenue Service, other states, and the Multistate Tax Commission (Chapters 32 and 143, RSMo). In addition, statutorily provided non-tax uses are: (1) to provide information to the Department of Higher Education with respect to applicants for financial assistance under Chapter 173, RSMo and (2) to offset refunds against amounts due to a state agency by a person or entity (Chapter 143, RSMo). Information furnished to other agencies or persons shall be used solely for the purpose of administering tax laws or the specific laws administered by the person having the statutory right to obtain it [as indicated above]. In addition, information may be disclosed to the public regarding the name of a tax credit recipient and the amount issued to such recipient (Chapter 135, RSMo). (For the Department's authority to prescribe forms and to require furnishing of social security numbers, see Chapters 135, 143, and 144, RSMo.)

You are required to provide your social security number on your tax return. Failure to provide your social security number or providing a false social security number may result in criminal action against you.

Missouri Department of Revenue

September 24, 2008 DT28601

PROPERTY TAX CREDITS - Qualification Types 2007

Senior Citizens		Disabled Veterans		100% Disabled		Widows/Widowers		TOTALS	
121,166	$ 53,579,714	1,783	$ 953,014	69,379	$ 35,688,523	2,803	$ 1,272,281	195,131	$91,493,532

PROPERTY TAX CREDITS - Owners vs. Renters 2007

	Senior Citizens		Disabled Veterans		100% Disabled		Widows/Widowers		TOTALS	
Renters	50,518	$ 24,965,157	998	$ 570,212	55,578	$ 30,009,170	945	$ 468,065	108,039	$56,012,604
Owners	68,844	$ 27,807,984	761	$ 369,764	13,106	$ 5,345,338	1,803	$ 778,129	84,514	$34,301,215
Both	1,804	$ 806,573	24	$ 13,038	695	$ 334,015	55	$ 26,087	2,578	$ 1,179,713
Totals	121,166	$ 53,579,714	1,783	$ 953,014	69,379	$ 35,688,523	2,803	$ 1,272,281	195,131	$91,493,532

PROPERTY TAX CREDITS - Owners/Rental Types 2007

A. Apartment, House, etc	71,331	37,671,200
B. Mobile Home Lot	3,291	1,385,327
C. Boarding Home / Res Care	7,623	4,590,152
D. Nursing Home	10,515	5,967,234
E. Hotel	132	70,617
F. Low Income Housing	13,695	5,701,342
G. Shared Residence	4,062	1,817,560
Total Renters	110,649	$ 57,203,432
Owner	84,482	34,290,100
Renter & Owner	2,578	1,179,713
TOTALS	195,131	$ 91,493,532

PROPERTY TAX CREDITS - Returns Filed 2007

MO-PTC	131,002	66,350,254
MO-1040/PTS	23,929	10,232,086
MO-1040P/PTS	3,982	1,596,873
MO-1040/PTS Electronically	36,218	13,314,319
Total 1040s	64,129	$ 25,143,278
TOTAL RETURNS	195,131	$ 91,493,532

Missouri Department of Revenue

January 25, 2010 DT28601

PROPERTY TAX CREDITS - Qualification Types 2008

Senior Citizens		Disabled Veterans		100% Disabled		Widows/Widowers		TOTALS	
137,731	$ 73,330,674	1,828	$ 1,093,523	70,924	$ 38,872,878	2,184	$ 1,239,485	212,667	$114,536,560

PROPERTY TAX CREDITS - Owners vs. Renters 2008

	Senior Citizens		Disabled Veterans		100% Disabled		Widows/Widowers		TOTALS	
Renters	52,772	$ 26,991,902	1,028	$ 587,407	56,392	$ 31,206,102	778	$ 411,903	110,970	$ 59,197,314
Owners	83,115	$ 45,288,025	783	$ 496,479	13,862	$ 7,286,145	1,382	$ 815,806	99,142	$ 53,886,455
Both	1,844	$ 1,050,746	17	$ 9,637	670	$ 380,631	24	$ 11,776	2,555	$ 1,452,791
Totals	137,731	$ 73,330,674	1,828	$ 1,093,523	70,924	$ 38,872,878	2,184	$ 1,239,485	212,667	$114,536,560

PROPERTY TAX CREDITS - Owners/Rental Types 2008

A. Apartment, House, etc	74,268	40,401,161
B. Mobile Home Lot	3,278	1,540,900
C. Boarding Home / Res Care	7,645	4,657,595
D. Nursing Home	10,801	6,317,091
E. Hotel	130	70,801
F. Low Income Housing	13,169	5,726,577
G. Shared Residence	4,260	1,952,143
Total Renters	113,551	$ 60,666,269
Owner	99,116	53,870,291
Renter & Owner	2,555	1,452,791
TOTALS	212,667	$ 114,536,560

PROPERTY TAX CREDITS - Returns Filed 2008

MO-PTC	137,323	75,460,333
MO-1040/PTS	27,655	14,727,148
MO-1040P/PTS	4,418	2,284,018
MO-1040/PTS Electronically	43,258	22,058,297
Total 1040s	75,331	$ 39,069,463
TOTAL RETURNS	212,654	$ 114,529,796

Missouri Department of Revenue

10/18/2010 **EDW Report**

PROPERTY TAX CREDITS - Qualification Types 2009

Senior Citizens		Disabled Veterans		100% Disabled		Widows/Widowers		TOTALS	
141,002	$ 72,768,582	1,854	$ 1,073,421	76,327	$ 41,015,952	2,030	$ 1,033,475	221,213	$115,891,430

PROPERTY TAX CREDITS - Owners vs. Renters

	Senior Citizens		Disabled Veterans		100% Disabled		Widows/Widowers		TOTALS	
Renters	45,831	$ 23,330,949	972	$ 556,517	58,805	$ 32,439,653	641	$ 311,178	106,249	$ 56,638,297
Owners	93,303	$ 48,451,413	872	$ 509,326	16,769	$ 8,167,227	1,365	$ 709,323	112,309	$ 57,837,289
Both	1,868	$ 986,221	10	$ 7,578	753	$ 409,072	24	$ 12,974	2,655	$ 1,415,845
Totals	141,002	72,768,582	1,854	1,073,421	76,327	41,015,952	2,030	1,033,475	221,213	115,891,430

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THE PROPERTY TAX CIRCUIT BREAKER:
An Introduction and Survey of Current Programs

By Karen Lyons, Sarah Farkas, and Nicholas Johnson

Many individuals and families who pay a high share of their income in property taxes are eligible for "property tax circuit breakers"— refunds provided by the state government to those whose property tax payments are deemed too great. Some 18 states deliver roughly $3 billion per year in circuit breaker programs.[1]

Circuit breaker programs share a common objective: to reduce the property tax liability for individuals whose property tax payments represent a large portion of their family's income. But the programs that the 18 states offer vary tremendously in scope and administration.

- In eight states, property tax circuit breakers are available only to senior citizens and people with disabilities; in 10 other states, they are available to families and individuals regardless of age or disability status.
- In 16 states, circuit breakers are available to both homeowners and renters. Renters qualify based on their rental payments, as it is assumed that property owners pass through a portion of their property taxes to tenants. In one state, only homeowners qualify, while in another state only renters qualify for the circuit breaker.
- Income ceilings vary widely by state. A few states allow only taxpayers with very low incomes — less than $20,000 — to receive circuit breakers. Others, such as Maine, Michigan, Minnesota, and New Jersey, extend their program to middle-income families whose property taxes are high relative to their incomes.
- Maximum benefits, too, vary widely, from $200 in Oklahoma to $2,000 in Maine.
- Nine states use a separate, stand-alone rebate process to administer their circuit breaker programs. Nine administer it as if it were part of the income tax, often offering stand-alone

[1] The District of Columbia is considered a state throughout this paper.

rebates to individuals who do not owe any income taxes.[2] One state administers its circuit breaker through the property tax system. These differences — and others — can affect public understanding of how circuit breakers work to reduce property taxes and participation among eligible taxpayers.

- The diversity of circuit breaker models results in great variation in states' fiscal contributions toward the programs. In some states, property tax circuit breakers represent a small fraction of property taxes paid – less than 0.10 percent in Oklahoma, Oregon and New York. In other states, such as Michigan, Minnesota and Vermont, circuit breakers represent over six percent of total property tax collections.

This report provides an introduction to property tax circuit breakers and describes the main features of circuit breaker programs currently being administered in the states.[3] Such features include eligibility restrictions based on whether the taxpayer is a homeowner or renter, on age or disability status, and on income level. The maximum benefit amounts, how these benefit are administered (i.e. as an income tax credit or state rebate check), and the cost of such programs are also addressed. Future Center on Budget and Policy Priorities analyses will discuss in greater detail how these different state programs compare with one another and the policy consequences of these differences.

What Are Property Tax Circuit Breakers?

Property tax circuit breakers, like the electrical devices that shut off electric power to prevent circuits from overloading, prevent property taxes from "overloading" a family's budget by "shutting off" property taxes once they exceed a certain share of the family's income.

The typical mechanism is this:

- The state establishes a maximum percentage of income that a qualifying household is expected to pay in property taxes. This can range from one percent to nine percent, depending on the state; in some states this percentage varies with the family's income level.

- If the household's property tax bill exceeds this limit, the state rebates either all or a portion of tax payments made above this limit. Circuit breakers are after-the-fact payments; taxpayers who participate in these programs are still required to pay their entire property tax bills upfront.

Circuit breaker programs are offered in 18 states in a variety of forms. (See Table 5) All of these programs, though, are directly linked to the percentage of income that the family pays in property tax and adhere to the structure discussed above: all or a portion of property taxes paid in excess of a maximum percentage of income is rebated.[4] (See Table 6) A number of other states offer similar

[2] Please note that one of Vermont's programs uses an income tax credit, while the other uses a rebate check. Thus, the state is included in both of those categories.

[3] This paper only looks at statewide circuit breaker programs. It does not take into account optional local programs available within a state.

[4] While state statutes explicitly list the maximum percentage of income and what portion of property taxes above this homeowners are expected to pay, many circuit breaker instructions do not. This is likely because these maximum

property tax credits to families who meet certain income requirements and who pay property taxes. But these credits are generally based on the family's income, not what share of the family's income goes towards paying property tax. (See box on page 4)

Why Are Circuit Breakers Needed?

A basic tenet of fair taxation is that taxes should be reasonably linked to the taxpayer's ability to pay. Tax payments should rise as incomes rise. For a substantial number of taxpayers, however, residential property taxes fail to meet this basic standard of fairness.

One group of taxpayers for whom residential property taxes are often high relative to income is those with low incomes. A study by the Institute on Taxation and Economic Policy finds that in 2002, low-income families paid an average of 3.0 percent of their income in property taxes and middle-income families paid 2.4 percent, while the richest taxpayers paid only 0.8 percent.[5] A few factors help explain this inequity.

A large body of evidence shows that lower-income families are much more likely to face high housing costs — usually defined as costs that exceed 30 percent of income — than are high-income families. Families below the poverty line typically spend 42 percent of their income on housing compared to the national median of 22 percent. [6] Families with high housing costs typically pay high property taxes relative to their incomes since property taxes within a given community tend to be roughly proportionate to housing costs.

Renters — who are disproportionately represented among low-income families— also can face high property taxes relative to their incomes. [7] This is because landlords generally pass along a substantial portion of property taxes to them in the form of higher rents.

A second group of taxpayers who may also face problematic levels of property taxes are those with relatively fixed incomes living in places where property values — and thus property tax assessments — are rising rapidly. [8] The classic example of such a situation is a senior citizen who has lived in her house for many decades and who recently has seen a large increase in the assessed

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percentages and portions vary according to income level. The instructions do, though, provide taxpayers with a table that takes these variables into account. They list different income ranges, property tax payment ranges and the corresponding property tax refund. See Missouri's Property Tax Credit Claim http://www.dor.mo.gov/tax/personal/individual/forms/2005/ptstable.pdf or Minnesota's Property Tax Refund http://www.taxes.state.mn.us/prop_refund/instructions/m1pr_inst.pdf.

[5] Institute on Taxation and Economic Policy, "ITEP Guide to Fair State and Local Taxes, "February 2005, http://www.itepnet.org/guide.htm.

[6] 2005 American Household Survey, U.S. Department of Housing and Urban Development and U.S. Census Bureau.

[7] According to the 2005 American Housing Survey, 31 percent of all households are renters, while 57.4 percent of households in poverty are renters. Table 2-1, 2005 American Housing Survey, US Census Bureau (www.census.gov/prod/2006pubs/h150-05.pdf)

[8] This could be a result of the house's location becoming more desirous due to new housing demands or commercial developments. It also could be because assessments were not carried out for a number of years and the old property values were substantially different from current market values.

Property Tax Credit Programs Similar to the Circuit Breaker

In addition to the programs described in this report, several other states offer property tax rebates or credits to taxpayers who have low incomes and pay property taxes. These programs are often described as circuit breakers and sometimes even have "circuit breaker" in their name, such as in Connecticut, Idaho and Utah. But they differ from true circuit breakers in this respect: the value of the credit or rebate is driven by a family's income without taking into account the *share* of the family's income that goes towards paying property tax.

Some of these programs, such as those in Arizona, Colorado, Idaho and Utah, provide flat payments that vary by income level. For example, in Utah, a family with an income of $10,000 qualifies for a $609 credit, while a family with an income of $15,000 qualifies for a $392 credit.

Other programs, such as those in Connecticut, Kansas, Iowa, Nevada, New Hampshire, North Dakota and South Dakota, rebate a percentage of property taxes paid that varies by income level. For example, a family earning $10,000 in Iowa qualifies for a rebate equal to 85 percent of property taxes paid, while a family earning $15,000 qualifies for a rebate equal to 35 percent of property taxes paid.

Unlike true circuit breaker programs, such credits are not targeted specifically to families with particularly high property tax bills relative to their incomes. For this reason, they are excluded from the analysis in the body of this report.

Not only do these programs fail to adjust for variations in actual property tax burdens, they also tend to be more restrictive than circuit breakers. They are generally offered only to seniors and have relatively low income ceilings.

value of this house. While the property tax *rate* for the community she lives in may fall to reflect her home's new higher value, this decrease may not fully offset the increase in her home's assessed value, leading to a higher property tax bill. This could be because the demand for public services supported by the property tax has also increased or because the values of other property in the same community have fallen.

This situation is not limited to senior citizens. The recent rapid increase in many communities' property values has meant that many younger, working families are also facing property tax bills that are increasingly out of line with their incomes.

A third group of taxpayers whose property taxes may be high relative to income — at least temporarily — are those who have experienced a sudden decline in their incomes, for instance as a result of job loss. As long as the family endures the economic hardship, their ability to pay property taxes is hampered.

In all of these situations, circuit breakers provide direct assistance to families whose ability to pay property taxes has become inadequate relative to their property tax bills.

Who is Eligible for Circuit Breaker Programs?

States limit eligibility for circuit breaker programs in three ways: whether the taxpayer is a homeowner or renter; whether the taxpayer is a senior citizen or disabled; and the income level of

the taxpayer. These requirements vary greatly from state to state and significantly affect the breadth of the program and its ability to offset property taxes for families that are in need of assistance.

Homeowners and Renters

Most circuit breakers are available to both homeowners and renters since they both pay property tax. Homeowners receive an actual bill in the mail that they can pay directly by check or indirectly as part of their mortgage payments. Renters pay property tax implicitly as part of their monthly rent payments. (Landlords typically take property tax liability into account when they set rents, so higher property taxes generally result in higher rents.) In 2006, circuit breakers were offered to homeowners and renters in 16 states, to only homeowners in one state and to only renters in one state. (See Table 1)

In order for the state to provide renters with rebates, it must make an assumption about how much of the rent payment constitutes property tax; the actual amount of property tax that owners of real estate pass on to renters through higher rent is unknown. This "property tax rent equivalent" is usually expressed as a percentage of rent paid and ranges from six percent to 25 percent. (See Table 2)

For example, consider a Vermont family that earned $30,000 in 2005 and rented a home at a rental rate of $700 per month for a yearly total of $8,400. Vermont's property tax rent equivalent is 21 percent, making this family's "property tax bill" for 2005 equal to $1,764. At their income level, the family is required to pay five percent of their income (or $1,500) in property taxes before they receive a credit, but everything they pay over this amount will be rebated to them by the state. The income tax credit amount will, therefore, equal $264 ($1,764 minus $1,500).

Property tax rent equivalents are typically set in statute. A state could set these rent equivalents based on empirical or theoretical analysis of the relationship between rents and property taxes. It is unclear whether any states have conducted such analyses in recent years.

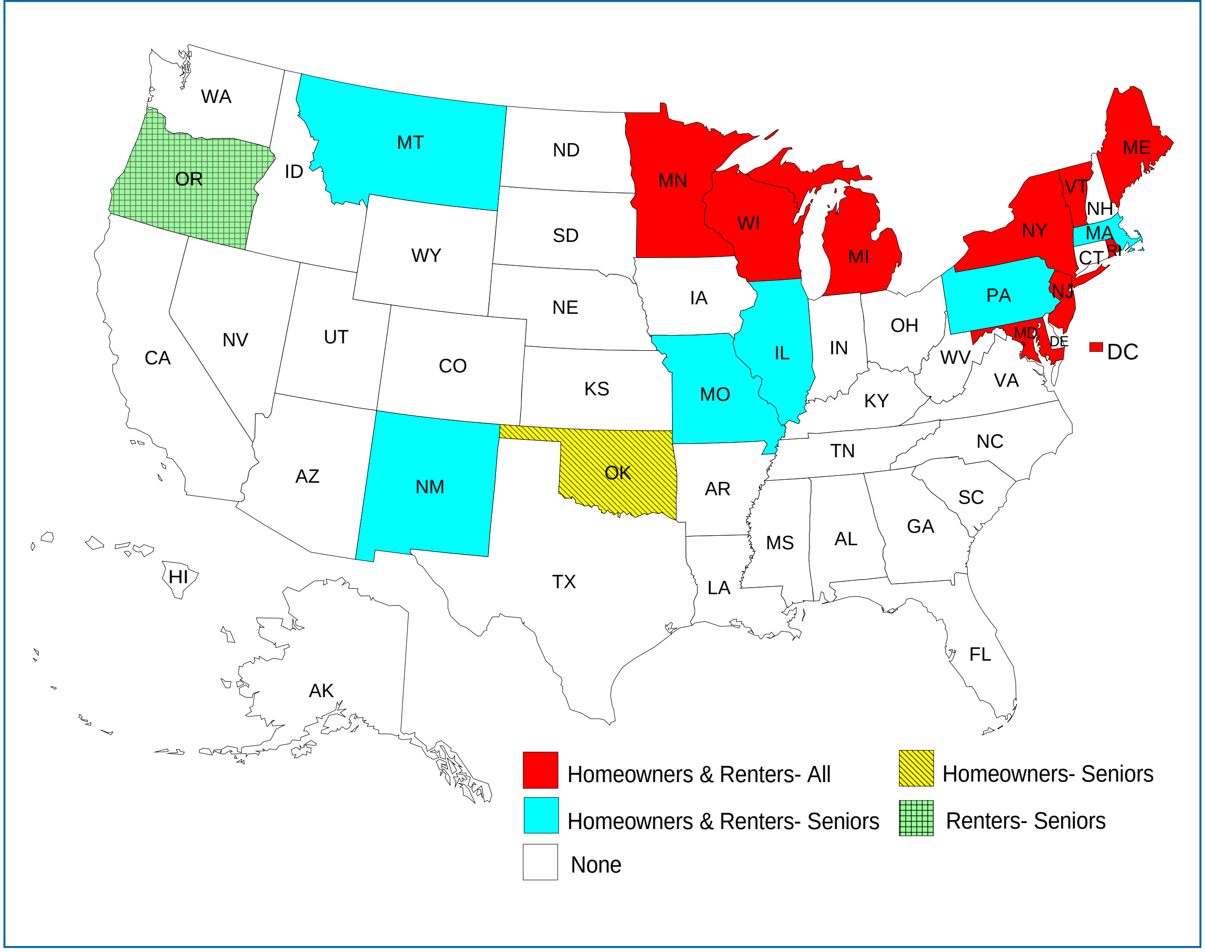
Senior Citizens and Disabled Residents

Participation in eight of the 18 states with circuit breaker programs is restricted to senior citizens or disabled residents. (See Table 1) These groups often are seen as those with the greatest need because they have a limited ability to generate income. Nevertheless, other low-income groups may also face high property tax bills relative to their income. Circuit breaker programs that include anyone who meets income eligibility requirements ensure property tax reductions go to a range of needy households.

Income Ceilings

All states set a maximum income or wealth limitation, above which households do not qualify for the circuit breaker program. In some cases, these limitations are very restrictive. For example, Oregon's circuit breaker has an income ceiling of $10,000, the lowest in the nation. The federal poverty line for a two person household is $12,755, meaning that a couple in Oregon with income below the poverty line is too well off to benefit.

FIGURE 1: Who Is Eligible for Circuit Breakers (FY 2006/TY 2005)?



Other states' income ceilings are much more generous and allow families with moderate incomes — or even relatively high incomes — to participate if they have high property taxes relative to their income. For example, New Jersey's circuit breaker has an income ceiling of $200,000. (See Table 3)

Note that even with generous income ceilings, participation among middle-income families is limited by the requirement that property tax liability exceed a certain percentage of income. For this reason, even in the absence of restrictive limits, lower-income families are more likely to qualify for a circuit breaker than middle-income families.

In general, circuit breakers limited to senior citizens and those with disabilities tend to have stricter income limitations than do circuit breakers that are open to everyone. Of the eight circuit breaker programs limited to seniors and disabled persons, half have income ceilings between $10,000 and $19,999. Only one circuit breaker program open to everyone has such a low ceiling. On the opposite end of the spectrum, five of the 10 states that offer circuit breakers to everyone have income ceilings greater than $70,000. No program limited to seniors and disabled persons has such a high ceiling.

What Are the Maximum Benefits?

The circuit breaker formula, which takes into account property taxes and income, determines the level of benefits that a taxpayer may receive. But this is true only up to a point: the amount of benefit is typically capped at a specific dollar level, regardless of actual property tax liability. Often this limit varies by income level, so that families with lower incomes are eligible for larger maximum amounts than families with higher incomes. The cap ranges from $200 for elderly and disabled homeowners in Oklahoma to $2,100 for elderly and disabled renters in Oregon. The greatest maximum benefit for states that offer the circuit breaker to both renters and homeowners is $2,000 in Maine. (See Table 4)

Finally, maximum benefits do not seem to be closely correlated with income limits. That is, not all states with low income limits have similarly low maximum benefits. For instance, Oregon has a low income ceiling of $10,000, but a high maximum benefit of $2,100. It is unlikely, though, that anyone claims this maximum benefit.

States prefer to put caps on maximum benefits because doing so limits the cost of the program and controls the rate at which this cost grows over time. But an overly restrictive cap limits a circuit breaker's capacity to reduce property tax liabilities. For example, New York's maximum benefit is $75 for those under 65, regardless of actual property tax liability or income. Even if a family receives the maximum benefit — they may qualify for less— in most cases this small sum cannot provide meaningful assistance with property tax bills.

How Are Circuit Breaker Credits Administered?

How a state administers its circuit breaker program can have at least two major consequences: it can affect the likelihood that an eligible taxpayer will participate in the program, and it can affect the public perception of the program as an effective way of improving the property tax's fairness.

States typically use one of three mechanisms to deliver property tax circuit breakers: a direct rebate check, an income tax credit, or a credit for future property tax bills. (See Table 5)

One approach is to set up a stand-alone program through which taxpayers can apply for and receive a refund check. Nine of the 18 states use this method. A disadvantage of a stand-alone program is that only a portion of eligible taxpayers — perhaps as few as one-third to one-half — may be expected to participate, in part because they may not be fully aware of the program or may not know that they are eligible.[9]

Equally as common is rebating money via the state income tax form, which is done in nine states. In seven of these nine states, individuals who qualify for the program, but who are not required to

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[9] For example, according to Maine's Revenue Service, only 41 percent of eligible taxpayers applied for the state's circuit breaker program. Seth Harkness**,** "Mainers Forgoing New Tax Savings," *Portland Press Herald*, September 7, 2006**.** See also Andrew Reschovsky, "The State Role in Providing Property Tax Relief," presentation for Nevada Legislature, 2005; and David Baer, "State Programs and Practices for Reducing Residential Property Taxes," AARP Public Policy Institute, May 2003.

file an income tax return, file just the circuit breaker credit portion of the return. In these cases, the credit is given as a refund check. Administering the program through the income tax reduces the problem of non-participation because most families (including most non-elderly low-income families) do file income taxes, even if only to claim withholding taxes or other tax credits.

But structuring the circuit breaker as a provision of the income tax can reduce taxpayers' awareness that the credit is functioning as a form of property tax relief. Academic research has shown that taxpayers often resist the idea that increased fairness in one tax offsets unfairness in another tax.[10]

In one state— Maryland —the property tax circuit breaker is applied as a property tax credit against future property tax bills. (Renters receive rebate checks.) The advantage here is the explicit link that is made to property tax liability. The disadvantage is that if the homeowner moves, he loses his credit.

How Much Do Circuit Breaker Programs Cost?

The cost of a circuit breaker program to a state treasury depends on all of the variables described above: eligibility requirements, maximum benefits, the formula through which the benefit is calculated, and the percentage of eligible taxpayers who participate in the program.

Every state with a circuit breaker program tracks how much they have provided in property tax refunds through the program. Therefore, one way to get a sense of the impact of these programs is to compare the total amount rebated to 2004 total property tax collections, as reported by the US Census Bureau.[11] (It should be noted that property tax collections include collections of taxes on real property *and* personal property.[12]) (See Table 5)

Some circuit breaker rebates constitute a miniscule portion of total property tax collections. In Oklahoma, for instance, circuit breaker benefits as a share of total property tax collections total one-fiftieth of one percent. Its program is limited to seniors and disabled persons and has a low income ceiling and maximum benefit amount.

On the opposite end of the spectrum is Vermont. Its two circuit breaker programs provide benefits equal to 11.4 percent of total property tax collections.[13] Its Education Property Tax Payment, which is available to all homeowners with incomes up to $110,000, provides benefits equal

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10 See for instance Edward J. McCaffery and Jonathan Baron, "Heuristics and Biases in Thinking About Tax," *Proceedings: 96th Annual Conference on Taxation, 2003,* National Tax Association, 2004.

11 See Notes and Sources for further information.

12 The Census definition is: Property refers to real property (e.g., land and structures) as well as personal property; personal property can be either tangible (e.g., automobiles and boats) or intangible (e.g., bank accounts and stocks and bonds). Special property taxes, levied on selected types of property (e.g., oil and gas properties, house trailers, motor vehicles, and intangibles) and subject to rates not directly related to general property tax rates. Taxes based on income produced by property as a measure of its value on the assessment date. Penalties and interest on delinquent property taxes; proceeds of tax sales and tax redemptions, up to the amount of taxes due plus penalties and interest. For governments collecting taxes as agents for another, includes any commissions, fees, or other items representing collection expenses retained from tax proceeds. http://www.census.gov/govs/www/qtaxtechdoc.html

13 The state is currently merging these two programs together.

to 8.1 percent of all property tax collections. And its Property Tax Rebate, which is available to all homeowners and renters with incomes up to $47,000, provides benefits equal to 3.3 percent of all property tax collections.

States usually bear the costs of circuit breaker programs, funding them out of the general fund. This allows the property tax itself to continue to fund essential services like education at the local level. When the rebate is administered at the local level via a property tax credit, the state normally reimburses the locality for the foregone revenue.

APPENDIX

TABLE 1. GENERAL ELIGIBILITY REQUIREMENTS FOR STATE CIRCUIT BREAKER PROGRAMS		
	Limited to Seniors and People with Disabilities (8 states)	Available to All (10 states)
Homeowners & Renters (16 states)	Illinois Massachusetts Missouri Montana New Mexico Pennsylvania	District of Columbia Maine Maryland Michigan Minnesota New Jersey* New York Rhode Island Vermont** Wisconsin
Homeowners (1 state)	Oklahoma	
Renters Only (1 state)	Oregon	
No Circuit Breaker (32 states)	Arizona Alabama Alaska Arkansas California Colorado Connecticut Delaware Florida Georgia Hawaii Idaho Indiana Iowa Kansas Kentucky Louisiana	Mississippi Nebraska Nevada New Hampshire North Carolina North Dakota Ohio South Carolina South Dakota Tennessee Texas Utah Virginia Washington West Virginia Wyoming

* New Jersey's FAIR rebate program is a circuit breaker for all homeowners and renters age 65 and older. Renters under 65 get a flat credit that is not based on property taxes as a percentage of their income.

** Vermont has two programs for which all age groups are eligible, but one of the programs limits eligibility to homeowners while the other allows both renters and homeowners to apply.

TABLE 2. PROPERTY TAX RENT EQUIVALENTS IN STATE CIRCUIT BREAKER PROGRAMS FOR RENTERS		
State	Program Name	Property Tax Rent Equivalent*
DC	Individual Income Property Tax Credit	15% of rent paid
IL	Circuit Breaker	25% of rent paid
ME	Maine Residents Property Tax and Rent "Circuit Breaker" Refund	20% of rent paid
MD	Renters' Tax Credit Program	15% of rent paid
MA	Circuit Breaker Credit	25% of rent paid
MI	Homestead Property Tax Credit	20% of rent paid
MN	Property Tax Refund	19% of rent paid
MO	Property Tax Credit Claim	20% of rent paid
MT	Elderly Renter Credit	15% of rent paid
NJ	FAIR Rebate	18% of rent paid if tenant is 65 or older or disabled
NM	Property Tax Rebate	6% of rent paid
NY	Real Property Tax Credit for Homeowners and Renters	25% of rent paid
OR	Elderly Rental Assistance Program	None specified
PA	Property Tax/Rent Rebate	Varies; amount of rent refunded ranges from 20% for incomes below $5,500 to 2% for incomes between $13,000 and $15,000.
RI	Property Tax Relief Credit	20% of rent paid
VT	Property Tax Rebate	21% of rent paid
WI	Homestead Credit	25% of rent paid

* Figures listed assume that utilities are not included in rent payment. States typically adjust this figure if heat and/or other utilities are included.

TABLE 3. INCOME ELIGIBILITY LIMITS FOR STATE CIRCUIT BREAKER PROGRAMS		
Income Limit	Limited to Seniors and People with Disabilities	Available to All
$0 – 9,999		
$10,000 – 19,999	NM, OK*, OR**, PA	NY
$20,000 – 29,999	MO	DC, WI
$30,000 – 39,999	IL	RI
$40,000 – 49,999	MT	
$50,000 – 59,999	MA	
$60,000 – 69,999		MD
$70,000 or more		ME, MI, MN, NJ, VT***

* Program only for homeowners
** Program only for renters only
*** This is the income ceiling for the Education Property Tax Payment ("Prebate"). Vermont's other program—Property Tax Rebate—has an income ceiling of $47,000.

TABLE 4. MAXIMUM BENEFIT AMOUNTS FOR STATE CIRCUIT BREAKER PROGRAMS		
Maximum Annual Benefit	Limited to Seniors and People with Disabilities	Available to All
$0 – 199		
$200 – 399	NM, OK	NY**, RI
$400 – 599	PA	
$600 – 799	IL, MO	MD***, DC
$800 – 999	MA	
$1,000 – 1,199	MT	WI
$1,200 – 1,399		MI, NJ*
$1,400 or more	OR	ME, MN*
No specified limit		VT

* Renter credit is lower: MN is $1,350 and NJ is $824
**Maximum benefit is for people over 65; under 65 get a flat credit of $75.
*** Maximum benefit is for renters; there is no specified maximum benefit for homeowners.

TABLE 5. SUMMARY OF PROPERTY TAX CIRCUIT BREAKER PROGRAMS FOR 2006 (TY 2005) *Note: (h) refers to homeowners and (r) refers to renters*							
State	**Program Name**	**Renters Eligible?**	**Eligibility**	**Household Income Ceiling (single/ joint filer)**	**Maximum Benefit**	**Type of Rebate**	**Rebates as a % of Property Tax Collections (2004)**
DC	Individual Income Property Tax Credit	Yes	All	$20,000	$750	Income tax credit (filers) or rebate check (nonfilers)	0.94%
IL	Circuit Breaker	Yes	Age 65 and older, 16 and older and disabled, or surviving spouse 63 or older	$21,218 (1 person household); $28,480(2 person household); $35,740(3 person household)	$700	Rebate check	0.77%
ME	Maine Residents Property Tax and Rent "Circuit Breaker" Refund	Yes	All	$77,000/$102,000	$2,000	Rebate check	1.11%
MD	Homeowners' Property Tax Credit Program/Renters' Tax Credit Program	Yes- applicants under age 60 must have at least one dependent under 18 living with them	All	$60,000 & $200,000 net worth (excluding home) (h); $38,659 (renters under 60 in 9 person household); $30,000 (renters over 60)	Amount by which property taxes (based on no more than $300,000 of assessment) exceed established "Tax Limits" (h); $600 (r)	Property tax credit (h); rebate check (r)	0.71%
MA	Real Estate Tax Credit for Persons 65 and Older (Circuit Breaker Credit)	Yes	Age 65 and older	$45,000 ($58,000 if head of household)/$67,00; assessed value of principal residence cannot exceed $600,000	$840	Income tax credit	0.22%
MI	Homestead Property Tax Credit	Yes	All	$82,650	$1,200	Income tax credit (filers) or rebate check (nonfilers)	6.52%
MN	Property Tax Refund	Yes	All	$87,780 (h); $47,350 (r)	$1,640 (h); $1,350 (r)	Rebate check	6.03%

TABLE 5. SUMMARY OF PROPERTY TAX CIRCUIT BREAKER PROGRAMS FOR 2006 (TY 2005) - Continued							
State	Program Name	Renters Eligible?	Eligibility	Household Income Ceiling (single/ joint filer)	Maximum Benefit	Type of Rebate	Cost as % of Prop Tax Collections (2004)
MO	Property Tax Credit Claim	Yes	Age 65 and older, disabled, or age 60 and older receiving surviving spousal Social Security	$25,000/$27,000	$750 (h); lesser of 20% rent paid or $750 (r)	Rebate check	2.22%
MT	Elderly Homeowner/ Renter Credit	Yes	Age 62 and older	$45,000	$1,000	Income tax credit (filers) or rebate check (nonfilers)	1.27%
NJ	FAIR Rebate	Yes	All (h); age 65 or older (r)	$200,000 (h); $100,000 (r)	$1,200 (h); $825 (r)	Rebate check	5.64%
NM	Property Tax Rebate	Yes	Age 65 and older	$16,000	$250	Income tax credit	0.46%
NY	Real Property Tax Credit for Homeowners and Renters	Yes- average monthly rent must be $450 or less	All	$18,000; market value of home must not exceed $85,000	$375 (age 65 and older); $75 (under 65)	Income tax credit (filers) or rebate check (nonfilers)	0.09%
OK	Property Tax Refund	No	Age 65 and older or disabled	$12,000	$200	Rebate check	0.02%
OR	Elderly Rental Assistance Program	Yes- must have paid more than 20% of income for rent, fuel, and utilities	Renters only, age 58 and older	$10,000; asset limit of $25,000 if under age 65, no limit if over 65	$2,100	Rebate check	0.06%
PA	Property Tax/Rent Rebate Program	Yes	Age 65 and older, spouse age 65 or older, disabled, or widow age 50 and older	$15,000	$500	Rebate check	0.99%

TABLE 5. SUMMARY OF PROPERTY TAX CIRCUIT BREAKER PROGRAMS FOR 2006 (TY 2005) - Continued							
State	Program Name	Renters Eligible?	Eligibility	Household Income Ceiling (single/ joint filer)	Maximum Benefit	Type of Rebate	Cost as % of Prop Tax Collections (2004)
RI	Property Tax Relief Credit	Yes	All	$30,000	$250	Income tax credit (filers) or rebate check (nonfilers)	.34%
VT	Property Tax Rebate	Yes	All	$47,000	None- state rebates the difference between a maximum percentage of income claimant expected to pay in property taxes (3.5% -5.0%, depending on income) and the amount of property taxes actually owed	Income tax credit (filers) or rebate check (nonfilers)	3.30%
	Education Property Tax Payment ("Prebate")	No	All	$110,000	None- state rebates difference between maximum percentage of income claimant is expected to pay in school property taxes (2.0-4.5%, depending on income) and the projected amount of school property taxes owed (State provides $15,000 homestead exemption for lowest-income)	Rebate Check	8.06%
WI	Homestead Credit	Yes	All	$24,500	$1,160	Income tax credit (filers) or rebate check (nonfilers)	1.69%

TABLE 6: FORMULAS FOR CIRCUIT BREAKERS AVAILABLE TO ALL HOMEOWNERS AND RENTERS (Example of calculation is for a 4-person family at the federal poverty line of $19,971, except the New York calculation, which uses a 4-person family earning $17,000)*	
State	Credit and Percentage of Income
DC	Credit equals 75% to 95% of the amount by which property taxes exceed 1.0% to 4.0% of income. • Credit =.75 * (property tax – .035*income)
ME	Credit equals 50% of the amount by which property taxes exceed 4% to 8% of income. Credit equals 100% of the amount by which property taxes exceed 8% of income. • If paying 5% of income in property tax, credit =.50 * (property tax – .04* income) • If paying 9 % of income in property taxes, credit = .50 * (.08*income – .04*income) + (property tax – .08*income)
MD	Credit equals the total amount by which property taxes exceed 0% to 9% of income, according to the following formula: 0% of the first $8,000 of the combined household income; 4% of the next $4,000 of income; 6.5% of the next $4,000 of income; and 9% of all income above $16,000. • Credit = property tax-((4000*.04)+(4000*.065)+((income-16,000)*.09))
MI	Credit equals 60% of the amount by which property taxes exceed 3.5% of income. The credit is reduced by 10% for every $1,000 that income exceeds $73,650. • Credit = .60 * (property tax - .035*income)
MN	Credit equals 50% to 90% of the amount by which property taxes exceed 1% to 4% of income. • Credit = .65 * (property tax –.022*income)
NJ	Credit equals total amount by which property taxes exceed 5% of income. • Credit = property tax – .05*income
NY	Credit equals 25% to 50% of the amount by which property taxes exceed 3.5% to 6.5% of income. • Credit = .50 * (property tax – .065*income)
RI	Credit equals the total amount by which property taxes exceed 3% to 6% of income. • Credit= property tax – .06*income
VT	Credit equals the total amount by which property taxes exceed 3.5% to 5% of income. • Credit = property tax – .035*income
WI	For taxpayers with income < $8,000, credit equals 80% of property taxes. For taxpayers with income > $8,000, credit equals 80% of the amount by which property taxes exceed 8.788% of income over $8,000. • Credit = .80 * (property tax – .08788*(income-$8,000))

* New York's income limit is $18,000, so a family at the federal poverty line does not qualify for the program.

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About this Report

The ITEP Guide to Fair State and Local Taxes is designed to provide a basic overview of the most important issues in state and local tax policy, in simple and straightforward language. Along with this report, ITEP has published a series of policy briefs providing additional information on specific topics discussed in the Guide. These briefs can be downloaded from the ITEP Internet site at www.itepnet.org.

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The ITEP Guide To Fair State & Local Tax Policy
Table of Contents

Chapter 1. Tax Fairness Fundamentals 1
Why Tax Fairness Matters 3
Federal Taxes Matter, Too 4

Chapter 2. Basic Principles and Terms 5
Tax Policy Principles: A Introduction 5
Equity: Two Kinds of Tax Fairness 5
Adequacy 5
Simplicity 6
Exportability 6
Neutrality 7
Nuts and Bolts: Basic Tax Policy Terms 7
Tax Incidence 7
The Tax Base 8
The Tax Rate (or Rates) 8
Effective Rates versus Nominal Rates 9
The Interaction of State & Local Taxes with Federal Income Taxes 10
Conclusion 10

Chapter 3. Sales and Excise Taxes 11
How Sales Taxes Work 11
Sales Taxes Are Regressive 11
The “Equal Tax on Equal Purchases” Fallacy 12
Sales Taxes on Business—Who Pays? 12
A Volatile, Slow-Growth Tax 12
No Federal Deductibility 13
Sales Tax Reform: Issues and Options 13
Broadening the Sales Tax Base 13
Sales Tax Credits 14
Business Sales Tax “Loopholes?” 15
Should Sales Tax Apply to Services? 16
Should Internet Transactions be Taxed? 17
How Excise Taxes Work 18
Excise Taxes Are Regressive 18
A Slow-Growth Tax 19
No Federal Deductibility 19
“Sin” Taxes 19
Excise Tax Issues 19

Chapter 4. Property Taxes 20
The Property Tax: How it Works 20
A Regressive Tax 21
Business Property Taxes 22
Residential Rental Property 22
Personal Property Taxes 22
Revenue and Stability 23
Deductible in Computing Federal Income Tax 23
Property Tax Relief Options 24
Homestead Exemptions 24
Circuit Breakers 24
Split Roll 25
Income Tax Breaks for Property Taxes 26
Property Tax Issues 26
Property Taxes and Education Financing 26
Assessment Practices 27
Conclusion 27

CHAPTER 5. PERSONAL INCOME TAXES 28
- How It Works 28
  - Which Income is Taxed—and Which Is Exempt? 28
  - "Adjustments" and Adjusted Gross Income 29
  - Computing Taxable Income 30
  - Tax Rates 31
  - Credits 32
- Local Income Taxes 33
- Revenue and Stability 33
- Deductible in Computing Federal Income Tax 33
- How Fair Is Your Income Tax? 33
  - Graduated Rate Structures 33
  - Capital Gains Tax Breaks 34
  - Pension Tax Breaks 34
  - Deduction of Federal Income Taxes from State Taxable Income 35
  - Tax Breaks for Middle- and Low-Income Families 35
- Conclusion 35

CHAPTER 6. CORPORATE INCOME TAXES 36
- Why Tax Corporations? 36
- How It Works 36
- Fairness 38
- Corporate Minimum Taxes 38
- Deductible in Computing Federal Income Tax 39
- Revenue and Stability 39
- Corporate Income Tax Issues 39
  - Tax Credits and the Incentive Illusion 39
  - Manipulating Apportionment Rules in the Name of Economic Development? 40
  - Separate Accounting & Transfer Pricing 41
  - "Nowhere Income" and the Throwback/Throwout Rule 42
  - Splitting Hairs? Exploiting the Business/Nonbusiness Income Distinction 42
  - Corporate Disclosure: An Important Tool for Tax Fairness 43

CHAPTER 7. OTHER REVENUE SOURCES 44
- Estate and Inheritance Taxes 44
- Gambling Revenues 44

CHAPTER 8. THINKING OUTSIDE THE BOX: OTHER TAXES 46
- Value-Added Taxes (VATs) 46
  - Why Adopt a VAT? 47
  - Problems with a VAT 47
- Gross Receipts Taxes 48

CHAPTER 9. TAXES AND ECONOMIC DEVELOPMENT 49
- How Taxes Affect State Economies 49
- Why Low-Tax Strategies Don't Work 51
- Ensuring Accountability in Economic Development Strategies 52
- Is Business the Enemy? (No) 52

CHAPTER 10. OTHER STEPS TOWARD (OR AWAY FROM) FAIR TAXES 53
- Tax Expenditure Reports 53
- Tax Incidence Analysis 54
- Rainy Day Funds 54
- Tax and Expenditure Limitations (TELs) 55
- Good Choices, Bad Choices 55

CHAPTER 11. FIGHTING THE FIGHT 56
- Strategies for Progressive Tax Reform 56
- Resources for Further Investigation 57
- Final Thoughts 58

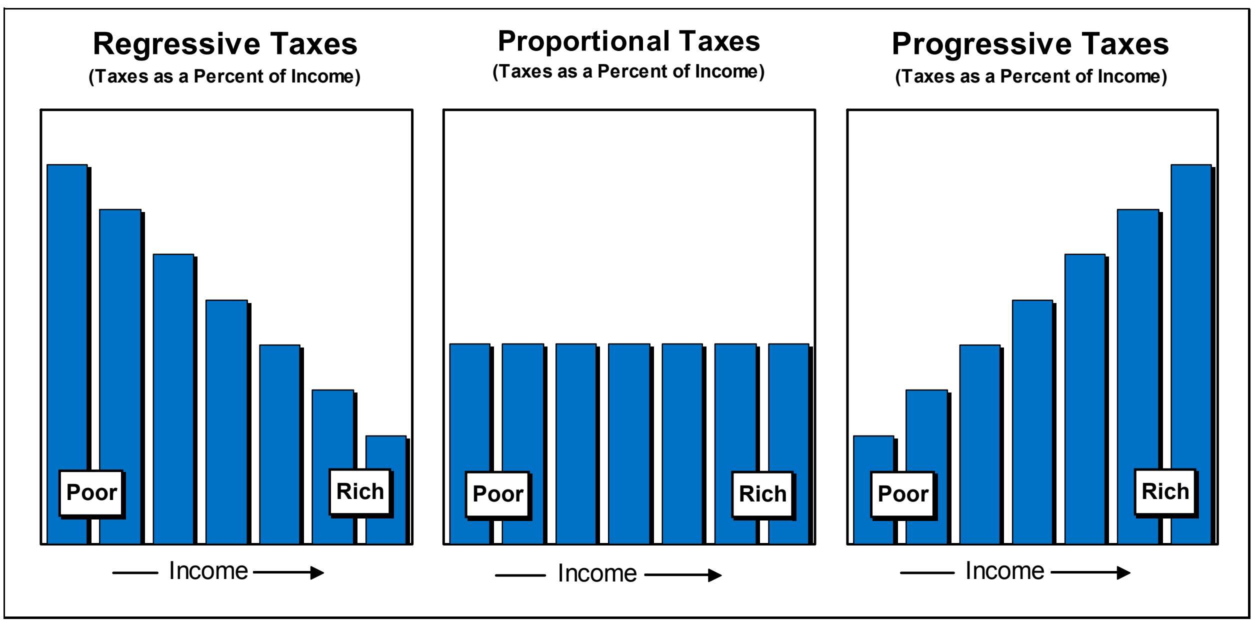
GLOSSARY 59

CHAPTER ONE
TAX FAIRNESS FUNDAMENTALS

> "The subjects of every state ought to contribute toward the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state . . . . [As Henry Home (Lord Kames) has written, a goal of taxation should be to] 'remedy inequality of riches as much as possible, by relieving the poor and burdening the rich.' "
>
> Adam Smith
> AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS (1776)[1]

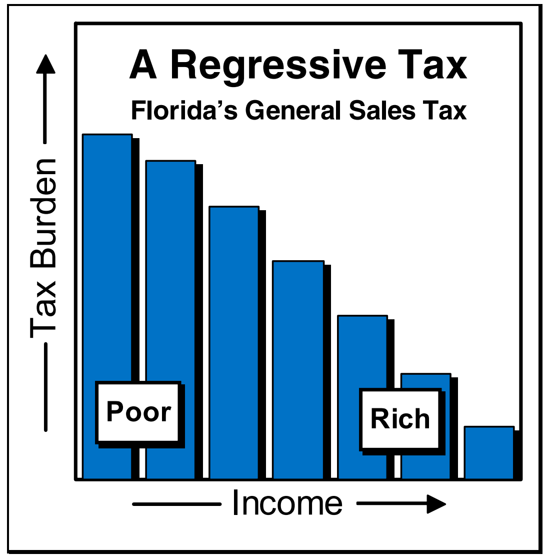
A fair tax system asks citizens to contribute to the cost of government services based on their **ability to pay**. This is a venerable idea, as old as the biblical notion that a few pennies from a poor woman's purse cost her more than many pieces of gold from a rich man's hoard. In discussing tax fairness, we use the terms regressive, proportional and progressive. As the charts below illustrate:

- A **regressive** tax makes middle- and low-income families pay a larger share of their incomes in taxes than the rich.
- A **proportional** tax takes the same percentage of income from everyone, regardless of how much or how little they earn.
- A **progressive** tax is one in which upper-income families pay a larger share of their incomes in tax than do those with lower incomes.

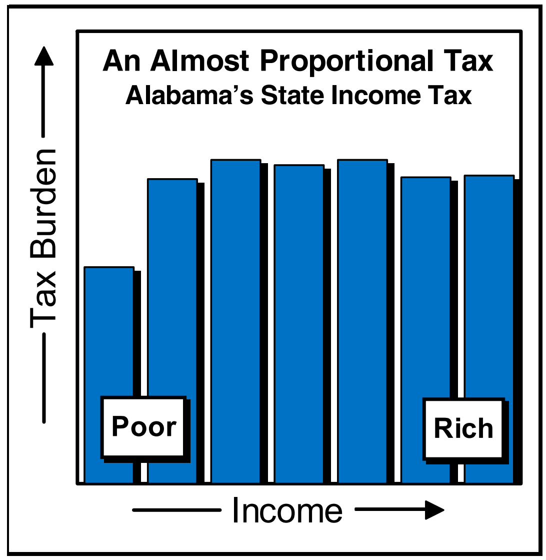


[1]Book V, Chapter II, part II, pp.777,779 (1937 ed.)

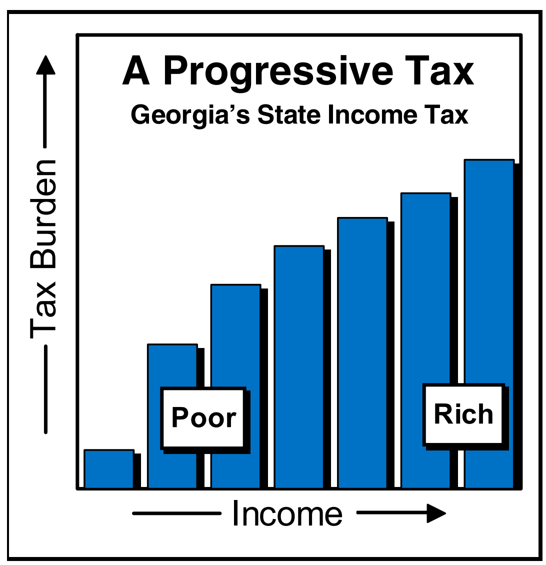
Few people would consider a tax system to be fair if the poorer you are, the more of your income you pay in taxes. But that's exactly what **regressive** taxes do. They reduce the standard of living of middle- and low-income families substantially, and have a much smaller impact on the wealthy. The sales tax is a regressive tax, as can be seen in the chart of Florida's sales tax. Excise taxes on cigarettes, gasoline and alcohol are also quite regressive, and property taxes are generally somewhat regressive.



Some believe that a **proportional**, or "flat," tax structure is fair. They argue that if everyone pays the same share of income in taxes, then everyone is treated equitably. But this view ignores the fact that taking the same share of income from a middle- or low-income family as from a rich family has vastly different consequences for each. Low-income families must spend most (or all) of their income just to achieve the most basic level of comfort. Even middle-income families spend most of what they earn to sustain only a modest standard of living. A tax on these families can cut directly into their quality of life. In contrast, the same tax will hardly affect the life style of the wealthiest families at all. An almost-flat personal income tax (like Alabama's, shown in the chart at right) is an example of a tax that can be proportional.[2]

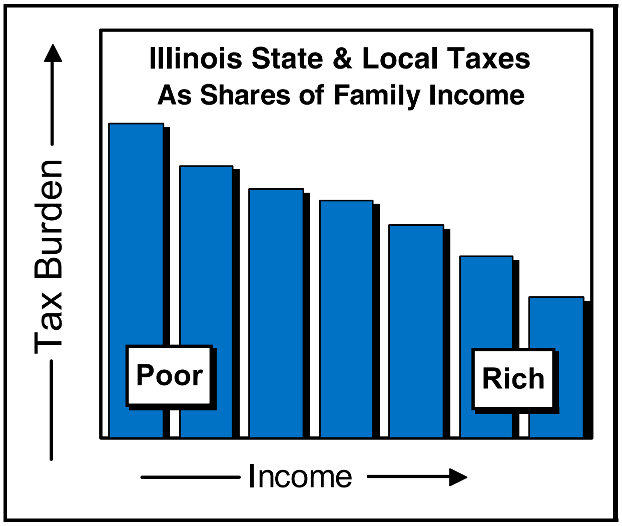


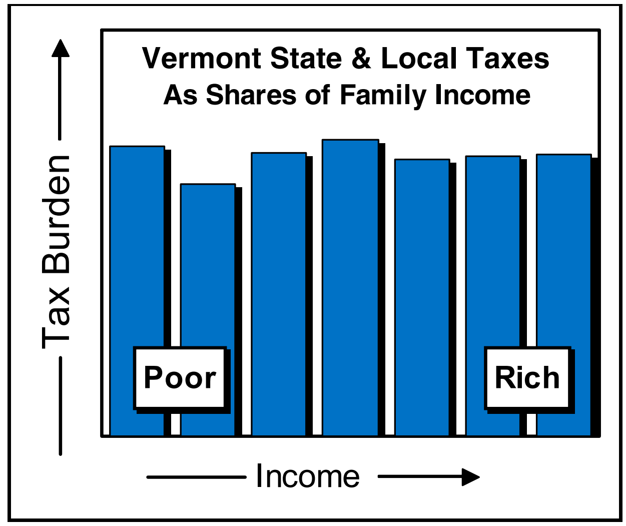
Progressive taxes are the fairest taxes. Personal income taxes are the only major tax that can easily be designed to be progressive. Low-income families can be exempted entirely and tax rates can be *graduated*, with higher tax rates applying to higher income levels, so that middle-income and rich families pay taxes fairly related to what they can afford. An example of a typically progressive income tax is Georgia's tax, shown in the chart at right: the poorest taxpayers pay the smallest amount as a share of income, and taxes increase with each income level.



Almost every state relies on some combination of regressive, proportional and progressive taxes. When you add these taxes together, the overall **progressivity** or **regressivity** of a tax system is determined by (1) the degree of progressivity or regressivity of each tax within the system and (2) how heavily a state relies on

[2]Alabama's income tax has a graduated rate structure, but more than 75 percent of taxpayers pay at the top rate. So it operates as an effectively flat income tax for most Alabamians.



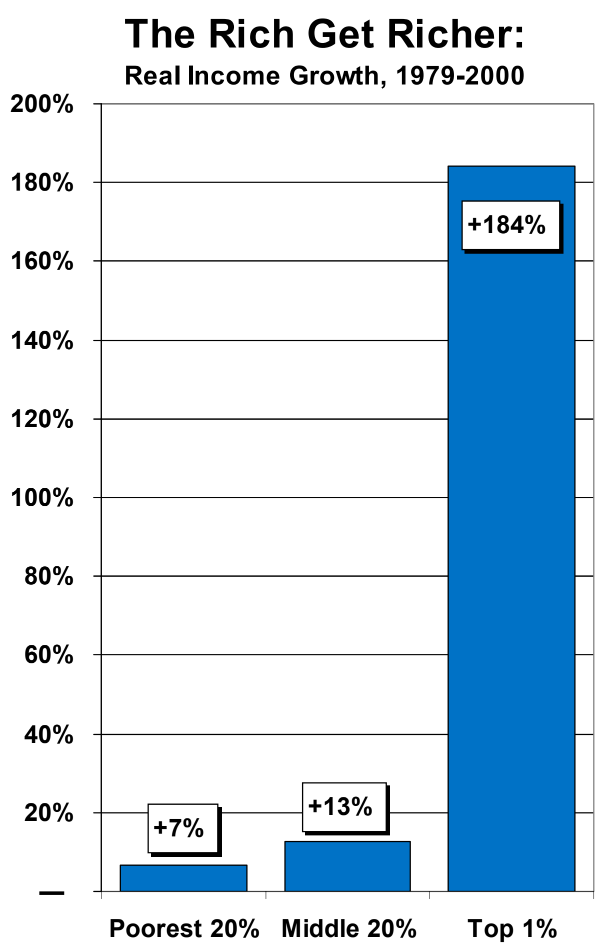


each tax. Thus, a state that relies on regressive sales, excise and property taxes more heavily than its mildly progressive income tax will end up with a very regressive tax system overall. An example of a state like this is Illinois. At the other end of the spectrum, even the most progressive income taxes are only sufficient to make a state's tax system roughly proportional overall. An example of a state that achieves this result by relying more on its progressive income tax than on regressive sales, excise and property taxes is Vermont.

Why Tax Fairness Matters

Tax fairness is an important goal for state policymakers, for several reasons. For one thing, a regressive tax system tries to raise money from the people who have the least of it. This is illogical at best. The wealthiest one percent of Americans have more income than the poorest 40 percent put together. And the best-off 20 percent of Americans make more than the remaining 80 percent combined. Soaking the poor just doesn't yield much revenue compared to modest taxes on the rich. Fair taxes are essential to adequate funding of public services because they tax those who have the most to give.

This flaw in using a "soak the poor," regressive tax system for raising revenue has been compounded in recent years. The wealthiest Americans have gotten much richer, while just about everyone else has gotten squeezed. The richest one percent of families in the United States saw their average pre-tax income rise by 184 percent in the twenty-one years from 1979 to 2000—that's in "constant dollars" (meaning it's adjusted for inflation)! Meanwhile, middle-income



earnings grew by 13 percent over this period, and the poorest twenty percent saw their real pretax incomes grow by less than 7 percent.[3]

It's no wonder that so many states with regressive tax structures are falling short in revenue. They're continually imposing higher taxes on people without much money—the very people who have experienced the most meager growth in income over the past twenty years. These states are largely bypassing—that is, by taxing at very low rates—the people whose incomes have grown the fastest: the rich. In the long run, progressive taxes like the income tax are a more dependable source of revenue for state and local governments precisely because they tax the wealthy state residents who have enjoyed the largest income gains in recent decades.

Fair taxes also help government in its relations with its citizens. The public accepts taxes because it values the services that government provides. When a tax system is unfair, however, there is a limit to the tax tolerance the public will show. It's one thing to ask people to pay taxes. It is another to ask them to pay more because others aren't paying their fair share. As Jean Baptiste Colbert, Louis XIV's controller general of finances reputedly said, "[t]he art of taxation consists in so plucking the goose as to get the most feathers with the least hissing." Fair taxes cause a lot less hissing.

> **Are Your State's Taxes Unfair?**
>
> A January 2003 ITEP report, *Who Pays?*, measures the fairness of state and local taxes in each of the 50 states and the District of Columbia. The report finds that almost every state requires its poorest citizens to pay more of their income in tax than any other income group—and allows the wealthiest taxpayers to pay the least. *Who Pays?* is available on ITEP's website at www.itepnet.org/whopays.htm.

Finally, a fair tax system is important as a very real moral imperative. Taxes can amount to real money for any family. But for poorer families, it's money that could otherwise be used for food, clothing, a trip to the doctor or some other necessity. When a state decides to tax the poor at a high rate, it is forcing these families to make choices that no family should have to make—choices that are far harder than those faced by upper-income families.

Federal Taxes Matter, Too

When we evaluate the fairness of a tax system, we should also consider overlapping tax systems that affect the same taxpayers. It is important, in particular, to consider state and local tax policy in the context of federal tax policy.

While the rich have seen their incomes go up substantially faster than others, federal taxes on the wealthy have gone way down—resulting in an overall tax system that is much less progressive. In 2004, the wealthiest 1 percent of Americans paid 32.8 percent of their income in combined federal, state and local taxes, down sharply from 37.1 percent before the George W. Bush administration. By comparison, the other 99 percent of Americans paid, on average, 29.4 percent of their income in total taxes—almost as much as the wealthiest taxpayers.

So as states determine which taxes to raise and on whom, they should consider that *federal* taxes have been getting significantly less progressive. A state that raises taxes on the rich will almost certainly still leave them better off than they were before their huge tax cuts on the federal level. Raising taxes on middle- and low-income taxpayers, however, will compound the injustice of the federal tax shift that has taken place in the past five years.

[3] Congressional Budget Office, *Effective Federal Tax Rates, 1997 to 2000.* August 2003.

CHAPTER TWO
BASIC PRINCIPLES AND TERMS

This chapter introduces some basic principles for evaluating your state's tax system—and walks you through some of the "nuts and bolts" necessary for a basic understanding of tax policy issues. This chapter does not attempt to turn anyone into a tax attorney. Rather, our goal—here and throughout this guide—is to make the reader sufficiently knowledgeable about tax policy to be an effective advocate for progressive tax reform.

Tax Policy Principles: An Introduction

Tax fairness is a primary consideration in evaluating state and local tax systems. But there are other important criteria that must also be considered. This section explains five of the most commonly cited tax policy principles: equity, adequacy, simplicity, exportability, and neutrality.

Equity: Two Kinds of Tax Fairness

When people discuss tax "fairness," they're talking about equity. Tax equity can be looked at in two important ways: **vertical equity** and **horizontal equity**. Vertical equity addresses how a tax affects different families from the bottom of the income spectrum to the top—from poor to rich. When we discussed regressive and progressive taxes in Chapter One, we were looking at vertical equity issues.

Horizontal equity is a measure of whether taxpayers in similar circumstances pay similar amounts of tax. For example, if one family pays higher taxes than a similar-income family next door, that violates "horizontal" fairness. This sort of unjustified disparity undermines public support for the tax system and diminishes people's willingness to file honest tax returns. It would be hard to defend a tax system that intentionally taxed left-handed people at higher rates than right-handed people. Likewise, a tax that hits a wage-earner harder than an investor (as the federal income tax currently does), even if their total incomes are the same, fails the test of horizontal equity.

> **Important Tax Policy Principles**
>
> ☞ **Equity:** Does your tax system treat people at different income levels, and people at the same income level, fairly?
>
> ☞ **Adequacy**: Does the tax system raise enough money, in the short run and the long run, to finance public services?
>
> ☞ **Simplicity:** Does the tax system allow confusing tax loopholes? Is it easy to understand how your state's taxes work?
>
> ☞ **Exportability:** Individuals and companies based in other states benefit from your state's public services. Do they pay their fair share?
>
> ☞ **Neutrality:** Does the tax system interfere with the investment and spending decisions of businesses and workers?

Adequacy

An adequate tax system raises enough funds, both in the short run and the long run, to sustain the level of public services demanded by citizens and policy makers. At the end of the day, adequacy is what separates successful tax systems from unsuccessful tax systems.

Two factors that contribute to the adequacy of a tax are its **stability** and its **elasticity**. A stable tax is one that grows at a predictable pace. Predictable growth makes it easier for lawmakers to put together budgets that match anticipated revenues to anticipated spending. But stability by itself is not enough to achieve adequacy in the long run. For example, property taxes grow predictably—but tend to grow more slowly than the cost of the services that state and local governments provide. Elasticity is a measure of whether the growth in a specific tax keeps up with the

economy—an important consideration because the cost of providing public services usually grows at least as fast as the economy. An elastic tax is one for which tax revenue grows faster than the economy over the long run.

There is some inherent tension between the goals of elasticity and stability. Elastic taxes, like the personal income tax, are more likely to ensure adequate revenues in the long run, but may also require frequent tax increases and reductions to ensure that state revenues match the desired level of government services. (The use of "rainy day funds" can make these legislative changes unnecessary—see Chapter Ten.) Stable taxes, like the property tax, will grow predictably, but the slower growth rate of these taxes may mean that in the long run tax hikes will probably be necessary to fund services at the same level.

The "Benefits Principle" of Taxation

Not all taxes are based on ability to pay. Governments sometimes levy taxes and user fees designed to make people pay in accordance with the benefit they receive from certain public services. This idea is known as the benefits principle of taxation. For example, states raise money for highway maintenance by imposing a gasoline tax. Since the amount of gasoline a driver purchases is a reasonable proxy for the benefit that driver receives from publicly maintained roads, the gas tax follows the benefits principle of taxation.

But there are limits to the usefulness of the benefits principle. First, taxing according to the benefits principle can lead to a regressive result: gasoline taxes take a larger share of income from low-income taxpayers than from the wealthy. Second, for many of the most important functions performed by governments, such as education, health care and anti-poverty programs, and police and homeland security, it can be hard to quantify the benefits of these services for individual taxpayers. Third, many of the services provided by state governments are explicitly designed to redistribute resources to low-income taxpayers. Social welfare programs exist partially because low-income taxpayers cannot afford to pay for these programs themselves, so requiring these taxpayers to pay for the programs according to the benefit principle would defeat their purpose.

Simplicity

Simplicity is often touted as a goal for tax reform—and it's an important one. Complicated tax rules make the tax system difficult for citizens to understand. Complexity also makes it harder for governments to monitor and enforce tax collections, and makes it easier for lawmakers to enact (and conceal) targeted tax breaks benefitting particular groups. A tax system full of loopholes gives those who can afford clever accountants an advantage over those who must wade through the tax code on their own.

But beware. Tax reform proposals described as "simplification" measures are often nothing of the kind. For example, anti-tax advocates frequently seek to "simplify" the income tax by eliminating the graduated rate structure and instituting a flat-rate tax. This is a red herring: a graduated tax system is no more complicated than a flat-rate tax. The right way to make income taxes simple is to eliminate tax loopholes, not to flatten the rates.

Exportability

The public services provided by state tax revenues are enjoyed by individuals and businesses from other states—including businesses that hire a state's high school and college graduates and tourists who use a state's transportation infrastructure. This is why state tax systems are often designed to make multi-state businesses and residents of other states pay their fair share of the state tax burden. An **exportable** tax is one that is at least partially paid by these non-residents.

There are broadly three ways in which taxes can be exported: by having non-residents pay the tax directly (sales taxes on items purchased by tourists, for example); by levying taxes on businesses which are then passed on to non-residents; and through interaction with the federal income tax. (See "The Interaction of State and Local Taxes with Federal Income Taxes" on page 10.) All taxes are at least partially paid by non-residents—and policy makers have the power to effectively adjust the percentage of taxes "exported" to residents of other states. Strategies for achieving this are outlined in later chapters of this guide.

Neutrality

The principle of neutrality (sometimes called "efficiency") tells us that a tax system should stay out of the way of economic decisions. If individuals or businesses make their investment or spending decisions based on the tax code rather than basing them on their own preferences, that's a violation of the neutrality principle, and can lead to negative economic consequences in the long run. For example, the big tax breaks that the Reagan administration provided for commercial real estate in the early 1980s led to far too much office construction and the phenomenon of "see-through office buildings" that nobody wanted to rent. These wasteful investments came, of course, at the expense of more productive investments—and were paid for by all other taxpayers.

The tax principles outlined here are not the only criteria used by policymakers in evaluating tax changes—and these principles sometimes come into conflict. But almost everyone would agree that advocates of tax reform should keep each of these goals in mind as they seek to improve their state's tax system.

Nuts and Bolts: Basic Tax Policy Terms

The tax principles described so far are essential to a broad understanding of why one type of tax is preferable to another. But there is also a basic set of terms you'll need to understand in order to understand how each of these taxes work. This section explores the "nuts and bolts" of state and local tax policy.

Tax Incidence

When we look at tax burdens on families at different income levels, we're engaging in what's called **incidence analysis**. Tax incidence analysis is designed to answer basic questions about how the current tax system and various proposed alternatives affect families at different income levels. On this page is an example of an **incidence table**. It shows the total amount of state and local taxes paid nationwide, as a percentage of each group's income. For example, the table shows that the poorest twenty percent of Americans paid, on average, 7.8 percent of their income in sales and excise taxes, while the wealthiest taxpayers paid 1.1 percent of their income in these taxes.

The first step in incidence analysis is to divide a population into income groups. ITEP's analyses usually divide the population into five groups based on income—ranging from the poorest 20 percent to the richest 20 percent. Each of these groups is called an "income quintile." ("Quintile" simply means one fifth, or 20 percent, of the population.)

ITEP's analyses also split the richest 20 percent into three subgroups: the lowest-income 15 percent of the quintile, the next 4 percent and the richest one percent. This is done because families in the top 20 percent have more than half of all personal income nationally. Within this quintile, there are substantial differences in income levels and tax burdens between the "poorest"

Total State & Local Taxes in 2002

As Shares of Income for Non-Elderly Taxpayers

Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%: Next 15%	Top 20%: Next 4%	Top 20%: TOP 1%
Average Income in Group	$9,900	$22,000	$36,100	$57,900	$98,100	$204,100	$950,000
Sales & Excise Taxes	7.8%	6.4%	5.1%	4.1%	3.1%	2.0%	1.1%
Property Taxes	3.1%	2.3%	2.5%	2.6%	2.6%	2.3%	1.4%
Income Taxes	0.6%	1.6%	2.3%	2.7%	3.2%	3.8%	4.8%
TOTAL TAXES	11.4%	10.4%	9.9%	9.4%	8.9%	8.1%	7.3%
Federal Deduction Offset	–0.0%	–0.1%	–0.3%	–0.6%	–1.2%	–1.6%	–2.0%
TOTAL AFTER OFFSET	11.4%	10.3%	9.6%	8.8%	7.7%	6.5%	5.2%

Source: ITEP, *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States* (2003)

members and the richest members. Incomes in this group range from what might be called upper-middle class, to the richest families in the country. From a tax policy standpoint, relatively lower-income families in this group should not be treated the same as the richest families because they have very different abilities to pay. This is why our incidence tables show them separately.

The Tax Base

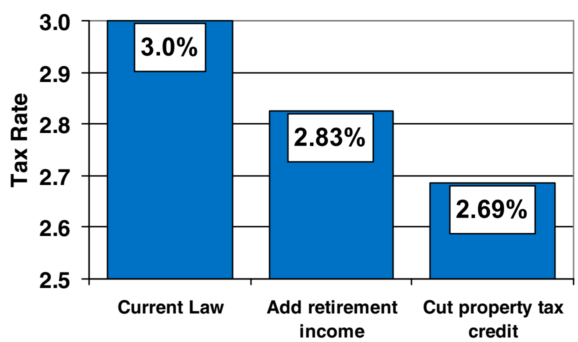
The **tax base** is all the items or activities subject to a tax. The tax base of a sales tax, for instance, is the amount paid for all the items that are subject to the tax. So, if the total amount a state's consumers paid in a year for taxable items is $2 billion, then the state's sales tax base is $2 billion.

Tax bases are usually measured as a dollar amount to which a tax rate is applied—for example, the total dollar amount of taxable income, in the case of the personal income tax, or the total dollar value of real estate, in the case of the real property tax. Taxes that are measured this way are called ***ad valorem***, or value-based, taxes. But not all taxes are calculated this way: excise taxes on cigarettes, gasoline and beer are often calculated on a per-unit basis. The amount of tax collected depends not on the value of the tax base, but on the number of items in the tax base. Cigarette taxes, for instance, typically are applied on a per-pack basis (the tax owed is a certain number of cents per pack of cigarettes sold). Thus, for a cigarette tax, the tax base is usually the number of packs sold. Taxes that are sold on a per-unit basis have one critical flaw—tax revenues only increase when the number of units sold goes up. By contrast, ad valorem taxes tend to grow with personal income even when the number of units sold is unchanged.

Taxes are often described as having a **broad base** or a **narrow base**. A broad-based tax is one that taxes most of the potential tax base. For example, a broad-based sales tax is one that applies to almost all purchases of goods and services. A narrow-based tax applies to fewer items. A typical narrow-based sales tax applies only to goods, not services, and has exemptions for things like food, housing and medicine.

In general, broader tax bases are a good idea. At any given tax rate, a broad-based tax will raise more revenue than a narrow-based tax—because more is taxed. The chart at right illustrates this: Illinois taxes personal income at a flat 3 percent rate. If lawmakers repealed a special tax break for retirement income, the tax rate could be lowered to 2.83 percent and still bring in the same amount of revenue. If lawmakers also repealed the state's property tax credit, a 2.69 percent rate would raise the same amount of money as the current tax. This example illustrates an important tradeoff: the broader the tax base, the lower the tax rates can be. And the narrower the tax base, the higher the tax rate must be in order to fund public services.

How Base Broadening Can Lower Tax Rates: The Illinois Income Tax



A broader base also makes it more likely that the tax system will treat all economic activities the same, which helps ensure that the tax system will not discriminate in favor of some taxpayers and against others. So a broad tax base helps achieve the goal of neutrality described above.

But sometimes there are good reasons for having a narrower base. Excluding food from the sales tax, for example, makes that tax less regressive. Some people argue that the benefit of making the tax less unfair outweighs the revenue loss from narrowing the sales tax base.

The Tax Rate (or Rates)

Multiplying the **tax rate** times the tax base gives the amount of tax collected. Usually, the tax rate is a percentage. For instance, if a state's sales tax rate is 4 percent on each taxable purchase and

taxable purchases (the tax base) total $1 billion, then the total amount of tax collected will be $40 million (4 percent of $1 billion).

Income taxes typically have multiple rates—with different rates applying at different levels of income. This is called a "graduated" rate structure, using "marginal" rates. Chapter Five describes how such a rate system works.

Not all tax rates are percentages. A typical gasoline tax rate, for example, is expressed in per-gallon terms. So if a state has a gasoline tax rate of 10 cents per gallon and 100 million gallons of gasoline are sold, then the tax collected will be $10 million (10 cents multiplied by 100 million).

Property tax rates are traditionally measured not in percentages but in **mills**. A mill represents a tenth of a percent. Mills tell us the tax for each thousand dollars in property value. Thus, a 20 mil rate applied to a house with a taxable value of $100,000 yields a tax of $2,000.

Effective Rates Versus Nominal Rates

So far, we have been describing **nominal tax rates**—the actual legal rate that is multiplied by the tax base to yield the amount of tax liability.

Though the nominal rate is used in the actual calculation of taxes, it's not the best measure for comparing taxes between states because it doesn't account for differences between tax bases. For example, suppose that two states, each with the same population and the same total amount of income, have sales taxes. The sales taxes have the same tax rate, 4 percent, but state A's sales tax applies to a narrow tax base, exempting groceries and many services, while state B's sales tax applies to a broader tax base. State B's sales tax (the total amount of statewide sales subject to the tax) applies to $1.5 billion of retail sales, while state A's sales tax applies to just $1 billion in sales. State B's sales tax is obviously much higher than State A's tax—even though the legal rates are identical. To compare these two sales taxes solely on the basis of the legal rates would be misleading.

Effective Tax Rates and Nominal Tax Rates

	State A	State B
Sales Tax Rate	4%	4%
Tax Base	$1 billion	$1.5 billion
Sales Tax Collected	$40 million	$60 million
Statewide Personal Income	$2 billion	$2 billion
Effective Sales Tax Rate	**2.0%**	**3.0%**

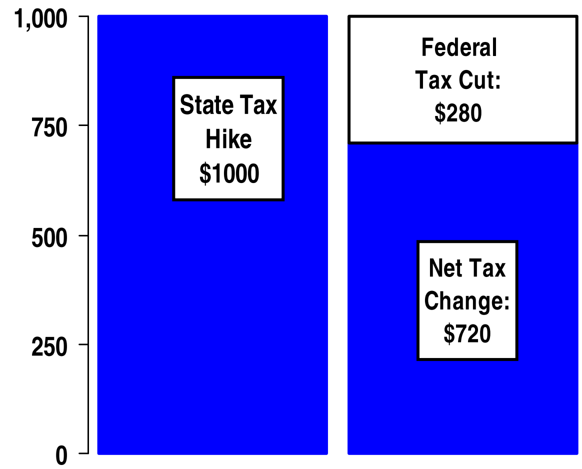
A better, more accurate measure for comparing these taxes is the **effective tax rate**. The idea of an effective rate is that instead of just saying "both state A and state B have four percent sales taxes," we say that "state A's sales tax takes 2.0 percent of the income of its residents while state B's takes 3.0 percent of personal income." This approach is better because it measures tax liability in a way that takes account of differences in the tax base. In this example, by comparing these effective rates we are able to see that, even though state A and state B have the same nominal rates, the tax is really higher in state B because state B has a broader base.

When we divide tax payments by personal income, as in the example above, we're calculating the **effective tax rate on income**, and this is the way taxes are usually measured in ITEP's incidence analyses. Effective tax rates can be calculated in other ways, too. For example, the property tax on a home can be expressed as a percentage of its market value. But what if we want to measure the tax compared to what the homeowner can afford? The owner of this home could be out of work—or could have just gotten a huge raise. Because we care about tax fairness, we need to measure the tax paid relative to ability to pay. Tax incidence tables—like the one presented in this chapter—are based on effective tax rates on income for families at different income levels because these tables are designed to determine the fairness of taxes. A fair tax takes more from those with a greater ability to pay, so the effective rate on income is higher on those with greater income. A regressive tax has lower effective rates on income for the rich than for middle- and low-income families.

The Interaction of State and Local Taxes With Federal Income Taxes

State taxes often have a direct impact on your federal tax bill. People who itemize deductions on their federal tax returns can deduct the state and local personal income taxes and property taxes they pay in computing their federal taxable income. Sales and excise taxes, by contrast, are generally not deductible on federal tax forms, although federal legislation passed in 2004 allows a temporary, optional sales tax deduction for taxpayers (mostly living in states without an income tax) who pay more sales tax than income tax. This optional deduction is only available in 2004 and 2005.) Thus, for every dollar in income or property taxes paid to a state or local government, taxpayers who itemize get a federal tax cut of as much as 35 cents (depending on what federal tax bracket they are in). The chart on this page shows this effect graphically. Suppose an itemizing taxpayer in the 28 percent federal tax bracket is subject to a $1,000 state income tax hike. The value of her federal itemized deductions will increase by $1,000. This means that $1,000 less of this taxpayer's income will be subject to federal tax after the state tax increase. Since this last increment of income was originally taxed at 28 percent, this person's federal tax liability decreases by $280 (28 percent of $1,000). So the net tax hike for this taxpayer is actually $720, not $1,000. An analysis that looked only at the *state* impact of the proposal would show a tax hike of $1,000, while an analysis that includes the offsetting federal change would show a tax hike of $720.

How Increases in Federally Deductible Taxes Reduce Federal Tax Burdens



This "federal offset" has clear implications for proposals to increase (or cut) state income and property taxes. When state income taxes go up, part of that tax hike will not come out of state residents' wallets at all, but instead will be paid by the federal government in the form of federal tax cuts for itemizers. Similarly, when state income taxes go down, federal income taxes paid by state residents will go up. And because the federal offset is most useful for wealthy taxpayers who are more likely to itemize and tend to pay at higher federal income tax rates, the best way to maximize the amount of a state income tax hike that will be offset by federal tax cuts is to target these tax hikes to the wealthiest state residents.

This benefit is not limited to income taxes paid by individuals. Corporations can export up to 35 percent of their state corporate income tax to the federal government. This means that when states enact corporate tax breaks for in-state businesses, up to 35 percent of these cuts may ultimately go not to the corporations for whom the tax breaks are intended, but to the federal government in the form of higher federal taxes.

The general inapplicability of the federal offset to sales and excise tax changes means that these regressive tax hikes are an especially bad deal for state residents, since virtually every dollar of a sales tax hike that is paid initially by state residents will ultimately come out of their pockets.

Conclusion

Now you've seen the basic conceptual building blocks of tax policy analysis. The next four chapters will take the concepts and terms you've learned here and apply them to each of the major types of taxes that state and local governments rely on. We'll look at how each tax matches up against the principles of taxation described in this chapter, and will look at reforms that could help each tax remain a viable revenue source for the 21st century. We'll also look at some broader reforms that can help ensure accountability and fairness in all types of taxes.

CHAPTER THREE

SALES AND EXCISE TAXES

Sales and excise taxes, or consumption taxes, are an important revenue source, comprising close to half of all state tax revenues in 2004. But these taxes are regressive, falling far more heavily on low- and middle income taxpayers than on the wealthy. Consumption taxes also face structural problems that threaten their future viability. This chapter looks at how these taxes work, and outlines options for making consumption taxes less unfair and more sustainable.

How Sales Taxes Work

Sales taxes apply to items we purchase every day, including goods (such as furniture and automobiles) and services (such as haircuts and car repairs). To compute the sales tax on a taxable item, the cost of the item is multiplied by the tax rate. For example, in Michigan, where the sales tax rate is six percent, the sales tax on a $10 book is sixty cents. The cost of the book to the consumer, after tax, is $10.60. The sales tax base is the total amount paid for all the goods and services subject to the tax. The sales tax is an example of an **ad valorem** tax—that is, a tax based on the price of the item sold.

In theory, the sales tax applies to all **retail transactions**—that is, sales to the final consumer. But every state allows some special exemptions. Almost all states exempt some items that can be thought of as "essentials"—rent and health care expenses are almost never taxed, for example. More than half of the states exempt groceries. Some states also exempt residential utilities such as electricity and natural gas, and a few states exempt sales of clothing. And in most states, the tax base does not include personal services such as haircuts.

States often have more than one sales tax rate. Some states apply lower tax rates to items such as groceries or utilities, as a means of providing low-income tax relief. Other states apply a higher tax rate to goods and services consumed primarily by tourists, such as hotels or rental cars. This is done to ensure that non-resident visitors pay their fair share of the sales tax.

Many states also have **local sales taxes**. These usually (but not always) apply to the same items as the state sales tax. Thus, calculating the total state and local sales tax is generally simply a matter of adding the state rate to the local rate and multiplying it by the cost of taxable items.

Every state with a sales tax also has a **use tax**, which applies to items that are bought outside a state for use within a state. The use tax is designed to prevent state residents from avoiding the sales tax by purchasing goods in other states. However, the use tax is rarely enforced.

Most states have more than one type of sales tax. They have a **general sales tax** (which is what most people mean when they talk about their state's "sales tax"), and **selective sales taxes** on particular goods or services. A typical selective sales tax—which may have a different rate than the general sales tax—is a tax on the purchase of alcohol, tobacco or gasoline, or a tax on utilities, such as electricity and telephone service. Selective sales taxes, also known as **excise taxes**, are discussed later in this chapter.

Sales Taxes Are Regressive

Sales taxes are inherently regressive because the lower a family's income, the more of its income the family must spend on things subject to the tax. Typically, low-income families spend three-quarters of their income on things subject to sales tax, middle-income families spend about half of their income on items subject to sales tax, and the richest families spend only about a sixth of their income on sales-taxable items. Thus, about three-quarters of the income of a low-income family, half of a middle-income family's income and just one-sixth of the income of a rich

family is typically subject to sales tax. Put another way, a 6 percent sales tax is the equivalent of an income tax with a 4.5 percent rate for the poor (that's three-quarters of the 6 percent sales tax rate), a 3 percent rate on the middle-class (half of 6 percent) and a one-percent income tax rate for the rich (one-sixth of 6 percent). Obviously, no one could get away with proposing an income tax that looked like that. The only reason this pattern is tolerated in consumption taxes is that their regressive nature is hidden in a harmless looking single rate, and the amount families pay is hidden in many small purchases throughout the year.

The sales tax violates the basic tax fairness principle of taxing according to one's ability to pay: the highest burdens are shouldered by those low-income taxpayers with the least ability to pay them. Sales taxes also violate this principle in their insensitivity to fluctuations in taxpayer income: families will always need to spend money on sales taxable items such as food, clothing and utilities no matter how little they earn in a given year. A middle-income taxpayer who loses his job will still have to spend much of his income just to get by—and will still pay a substantial amount of sales tax even though his ability to pay these taxes has fallen dramatically.

The "Equal Tax on Equal Purchases" Fallacy

Despite the regressivity of the sales tax, some people claim that sales taxes are fair. After all, it is said, no one can completely avoid paying sales taxes since they apply to things that everyone—rich and poor alike—needs to buy. The sales tax hits everyone "equally," goes this argument; the tax is the same on, say, a tube of toothpaste, no matter who buys it.

But this so-called "equality" is precisely why sales taxes *fail* the test of fairness. The cost of toothpaste, and therefore the sales tax on it, is the same for a rich person as for a poor person. But the rich person has many times more income. So the amount that the rich person pays in tax on that tube of toothpaste is a much smaller share of his or her income than the same tax on a middle- or low-income family.

Of course, a rich family does consume more and thus pays more sales tax in dollars than does a less well-off family. But in terms of what those dollars mean to rich families—as a portion of their income and how it affects their standard of living—the sales tax is much less of a burden on the rich than it is on middle- and low-income families.

Sales Taxes on Business—Who Pays?

Most state sales taxes are designed to exempt purchases made by businesses, on the theory that the sales tax is supposed to be a tax on final personal consumption. But the distinction between business and individual purchases is often difficult to make, and as a result every state applies its sales tax to some business purchases. These **business-input** sales taxes add to the cost of producing goods and services, and therefore they are mostly passed forward to consumers in the form of higher retail prices. In other words, taxing business inputs through the sales tax is generally akin to taxing the consumer more than once on the same retail sale. As a result, expanding the sales tax base to include business services will usually hurt low-income taxpayers.

Some of the sales tax paid by businesses is **exported** to out-of-state consumers. For example, Mississippi taxes industrial electrical use at a 1.5 percent rate. A Mississippi-based manufacturer that sells primarily to consumers in other states will likely be able to pass through most of the tax it pays on electricity to consumers in Texas, California, Massachusetts, and elsewhere. In this case, only a little of the tax hits Mississippi's middle- and low-income families.

A Volatile, Slow-Growth Tax

Sales taxes are a mainstay of state budgets nationwide. But during times of economic uncertainty, sales tax collections can be volatile. They can fall both when there is an economic

downturn and when people are afraid a downturn is coming. If a family thinks it may face hard times soon, it may delay some spending in anticipation of the worst. Purchases of big-ticket items like new cars are particularly likely to be postponed. As a result, sales tax revenues can fall during periods of economic uncertainty—even before a recession has set in.

Even in good economic times, the sales tax usually is not a fast-growing tax. The main reason for this is that sales taxes only reflect the income you spend. (By contrast, income taxes depend on the total amount of income you earn.) Sales taxes also grow more slowly than the economy for reasons that have to do with the antiquated tax base in many states: the fastest-growing area of personal consumption is services, which are currently not taxed by most states. The slow growth of sales taxes frequently forces lawmakers to increase the sales tax rate just to keep tax revenues growing with inflation.

No Federal Deductibility

Heavy reliance on sales taxes carries one big disadvantage for states: sales taxes are generally not deductible by itemizers in computing their federal taxable income. (2004 federal tax legislation allows residents of states without income taxes to temporarily deduct their sales taxes, but this tax break is only available in 2004 and 2005—and taxpayers must choose between deducting sales taxes and deducting income taxes, so this tax break will generally only benefit itemizers living in non-income tax states.) Because these taxes generally can't be written off on federal tax forms, every dollar of sales tax that is paid initially by state residents ultimately comes out of their pockets—and every dollar of a sales tax cut that goes to state residents remains in their pockets. In this sense, income and property taxes offer a much greater "bang for the buck" than sales and excise taxes—an important point as lawmakers decide which taxes to increase or cut.

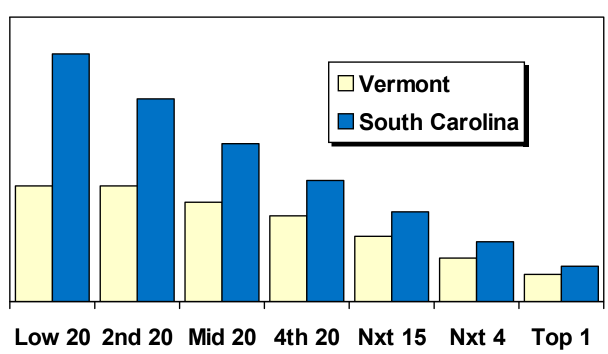
Sales Tax Reform: Issues and Options

As lawmakers struggle to bring the sales tax into the twenty-first century, they face difficult decisions ranging from the age-old question of how broad the sales tax base should be, to newly evolving concerns such as the wisdom of taxing services and of taxing Internet-based transactions. This section surveys problems facing the future of the sales tax.

Broadening the Sales Tax Base

Every state's sales tax allows targeted exemptions. These exemptions are usually intended to make the sales tax less unfair. Sales taxes can be made less regressive by taxing more of the things the wealthy consume the most and fewer of the things on which middle- and low-income families spend their money. Of course, every state and local general sales tax is regressive. But the degree of unfairness ranges substantially—from moderately regressive in states like Vermont to extremely regressive in states like South Carolina. The most important factor affecting regressivity is whether groceries are taxed. Taxing food is extremely regressive because such a high portion of the income of poorer families goes to mere sustenance.

Sales Tax Burdens in South Carolina and Vermont
As Share of Family Income



But there are reasons to be concerned about the long-term impact of proliferating sales tax exemptions. Economists generally argue that the sales tax base should be as broad as possible, for several reasons:

- Exemptions are very costly. Exempting groceries can reduce the revenue yield of each penny of sales tax by up to twenty percent. This puts pressure on lawmakers to increase tax rates.
- Exemptions are poorly targeted. The poorest 40 percent of taxpayers typically receive about 25 percent of the benefit from exempting food. The rest goes to wealthier taxpayers.
- Exemptions tend to make sales tax collections fluctuate more, because changes in particular economic sectors can affect tax collections. The broader the tax base, the less sensitive tax revenues will be to sudden swings in retail purchases of particular items.
- In states that allow local sales taxes, lawmakers must decide whether exemptions should apply to local taxes as well. Doing so can be costly to local governments, but not doing so creates more complication for retailers and tax administrators.
- While exemptions can make the sales tax less regressive, they also create a new source of unfairness: different treatment of taxpayers at a given income level. By exempting food while taxing other retail sales, lawmakers are discriminating against taxpayers who spend more of their money on things other than food.
- Exemptions are an administrative challenge to policy makers because any exemption requires a way of distinguishing between taxable and exempt products. For example, New York taxes marshmallows as snack food, but exempts mini-marshmallows as groceries. Exemptions require tax administrators to make countless decisions of this sort, and retailers must be familiar with all of these rules.

Sales Tax Credits

Lawmakers seeking to make the sales tax less unfair without breaking the bank do have an alternative to broad-based exemptions: targeted **sales tax credits**. These credits generally give a flat dollar amount for each member of a family, and are available only to taxpayers with income below a certain threshold. These credits are usually refundable, meaning that the value of the credit does not depend on the amount of taxes a claimant pays. This approach offers several advantages over sales tax exemptions: credits can be targeted to state residents only, and they can be designed to apply to whichever income groups are deemed worthy of tax relief. The box at right shows the details of one such program, the Kansas food sales tax refund. Low-income Kansas taxpayers over 55 years old, and non-elderly Kansans with children, can claim up to $72 for each family member. In 2004, Kansans with incomes up to $26,900 were eligible for the credit.

The Kansas Food Sales Tax Refund

Only taxpayers over 55, taxpayers with children under 18, and disabled taxpayers are eligible.

Income Level	Refund
$0 to $13,450	$72 per person
$13,451 to $26,900	$36 per person
$26,901 or more	no refund

The precise targeting of credits means that they are much less expensive—and much better targeted—than exemptions. Credits do not affect the sales tax base, so the long-term growth of sales tax revenues is more stable. And credits are easier for tax administrators to manage.

However, sales tax credits have one important disadvantage: they must be applied for. All of the states that allow sales tax credits require taxpayers to fill out a form every year. Taxpayers who do not know about the credit—or who do not have to file income tax forms—may not claim the credit even if they are eligible. This means that an effective outreach program must be a central part of any effort to provide sales tax credits. By contrast, exemptions are given automatically at the cash register—so consumers don't need to apply or even to know about them.

It is also important to recognize that sales tax credits will never be able to eliminate the regressivity of sales taxes. The Kansas sales tax remains quite regressive, even after the food sales tax refund. It would take a very large tax credit to eliminate the extra sales tax burden on low-income taxpayers. And while a state may be able to relieve the sales tax burden on low-income families through a credit, there is no practical way to make sales taxes on middle-income families

equal to the light sales taxes borne by the wealthy. Since low- and middle-income families bear most of the burden of the sales tax, a sales tax and rebate system that ended up taxing the middle class at the same low rate as the rich wouldn't be worth the trouble of collecting (and rebating).

To be sure, rebates or credits can be valuable to poor families. But no one should think that they can entirely solve the problem of sales tax regressivity.

Business Sales Tax "Loopholes?"

The sales tax is well enough understood that special interest loopholes in the tax law tend to get noticed, especially compared to some of the more complex tax breaks that are sometimes hidden in the income tax. That doesn't mean, however, that special interests don't work hard to get preferential sales tax treatment. Indeed, when states consider expanding their sales tax bases, lobbyists for such potential targets as lawyers, accountants, dry cleaners, advertising agencies, country clubs and others will fight tooth and nail for their exemptions.

On the other hand, one type of supposed "business loophole" in the sales tax—the tax exemption given for many purchases by businesses—is not simply the result of effective lobbying, but also is often based on sound economic principles. For example, nobody thinks that retailers should pay sales tax when they buy goods at wholesale. If they did, the goods would be taxed twice—once at the wholesale transaction and once at the retail sale—with the ultimate consumer bearing the burden of this double-taxation.

But the same principle applies when, for example, furniture-making companies buy wood to make into tables and chairs. If they must pay sales tax on the wood, then the wood will, in effect, be taxed twice—once when it is bought by the manufacturer, and again when it is bought by the consumer as part of the furniture. When sales taxes from earlier stages of the production process pile up on the final consumer, economists call it **pyramiding** or **cascading**.

Cascading sales taxes can create serious economic problems. For example, suppose one furniture manufacturer chops down trees, does all the wood machining, shaping and assembly itself, and runs its own retail stores. But another furniture manufacturer buys semi-finished wood from a lumber company, which in turn bought it from a timber company. And suppose that the second manufacturer sells its furniture at wholesale to unrelated retail stores. Only the final retail furniture sales of the first, integrated manufacturer will be taxed, since until then, the furniture and its components never change ownership. But under a "cascading" sales tax system, the products of the second manufacturer would be taxed four times: first when the wood is purchased by the lumber company, second when purchased by the furniture manufacturer, third when bought by retailers, and finally when sold to consumers at retail. Such a strange tax system would give the products of the integrated company a huge competitive advantage over those of the second manufacturer—even though the multi-company approach to furniture making and sale might be just as economically efficient.

An oddity created by taxing business inputs is that the effective sales tax rate on income (that is, sales taxes as a percentage of income) may actually end up higher than the nominal sales tax rate. In other words, a state can have a 5 percent sales tax rate but there may be families that have 6 percent of their income going to sales taxes. This is caused by two related phenomena. First, families pay a higher price for a product because the tax on the purchases by businesses increases the cost of making, wholesaling and retailing the product. Second, the retail sales tax applies to this added increment in the price, compounding the problem.

Taxing business inputs can also undermine the methods used to make the sales tax less unfair. For example, if grocery stores pay sales tax on the smocks they buy for their clerks or the fees they pay their lawyers, and these taxes are passed on to their customers in the form of higher retail food prices, the benefit of exempting food from the sales tax is partially undermined. These examples illustrate that supposed "business loopholes" in the sales tax must be analyzed to see if they are sensible rules or undeserved tax breaks.

Sales Tax Holidays—Boon or Boondoggle?

In recent years, lawmakers in more than a dozen states have sought to relieve the burden of sales taxes by enacting "sales tax holidays." These are temporary sales tax exemptions for clothing, computers, school supplies, and other "back to school" expenses. Most sales tax holidays last only a few days.

Virtually any sales tax cut will provide larger benefits, as a share of income, to low-income taxpayers than to the wealthy. But sales tax holidays are a problematic way of achieving low-income tax relief, for several reasons:

- A one-week sales tax holiday for selected items still forces taxpayers to pay sales tax on these items in the other fifty-one weeks of the year, leaving a regressive tax system basically unchanged.
- Any sales tax exemption creates administrative difficulties for state governments, and for the retailers who must collect the tax. But a temporary exemption requires retailers and tax administrators to wade through a sheaf of red tape for an exemption that lasts only a few days.
- Sales tax holidays are poorly targeted, providing tax breaks to both wealthy taxpayers and nonresidents.
- Many low-income taxpayers don't have the luxury of timing their purchases to coincide with week-long sales tax holidays. By contrast, wealthier taxpayers are likely to be able to time their purchases appropriately.
- Retailers know that consumers will shift their spending toward sales tax holidays to take advantage of the temporary tax exemption. Savvy retailers can take advantage of this shift by hiking prices during the holiday.
- Perhaps most important for cash-strapped lawmakers, sales tax holidays are costly. Revenue lost through sales tax holidays will ultimately have to be made up somewhere else.

Sales tax holidays do have advantages, of course. The biggest beneficiaries from a sales tax cut are the low- and middle-income families for whom these taxes are most burdensome. And the heavily-publicized manner in which sales tax holidays are typically administered means that taxpayers will be very aware of the tax cut they receive—and will know that state lawmakers are responsible for it.

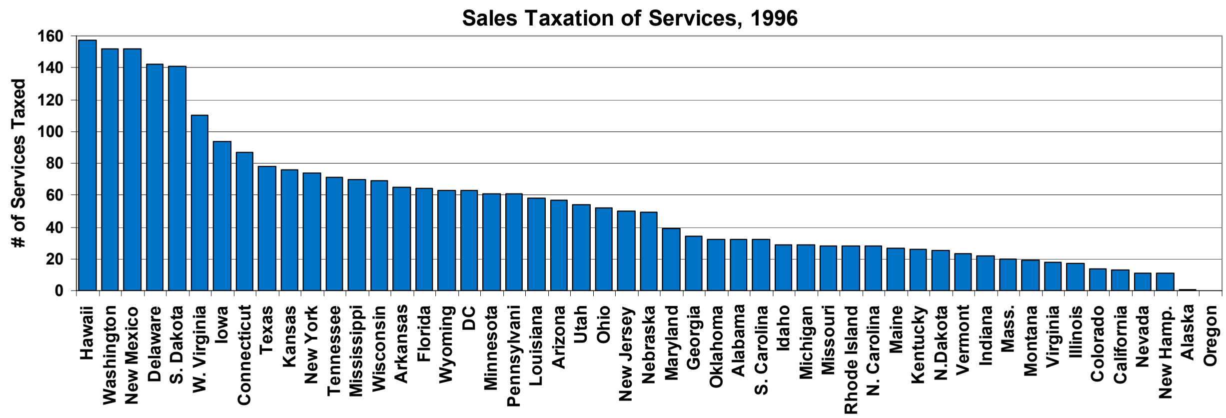
But in the long run, sales tax holidays are simply too insignificant to change the regressive nature of a state's tax system—and may lull lawmakers into believing that they have resolved the unfairness of sales taxes.

Should Sales Tax Apply to Services?

Most state sales taxes were enacted early in the twentieth century, at a time when most of the things people purchased were tangible goods like cars, furniture and books. But in the past fifty years, American consumer purchases have changed dramatically, shifting toward consumption of services like haircuts and car repairs. But few states have extended their sales tax to include services in their tax base. Only Hawaii, South Dakota, and New Mexico have a comprehensive service tax, and, according to the Federation of Tax Administrators, a majority of states still apply their sales tax to less than one-third of the 164 service categories that are potentially taxable. Though it can be politically difficult to accomplish, there are sound tax policy reasons for seeking to expand the sales tax base to include some—but not all—services.

The basic rule of thumb for which services should be taxed is very similar to the way states seek to tax goods: services consumed by individuals should be taxed, while services consumed by businesses in the process of producing goods and services of their own should be exempt. Taxing business services may seem tempting to lawmakers because of the potentially high revenue yield—but doing so will actually make sales taxes more unfair in the long run, since business sales taxes are (usually) passed through to consumers in the form of higher prices. Because these passed-through taxes are built into the prices of the goods we buy every day, the consumer doesn't see these hidden taxes—and the amount of this hidden tax that is included in any particular retail purchase will vary depending on the number of taxed stages in the production process for a given retail item. But consumers will, in general, feel the pain from efforts to impose sales taxes on business services.

Taxing personal services can make the sales tax more fair in two ways. First, taxing services helps ensure that the amount of sales tax anyone owes will depend primarily on how much they



spend—not what they spend it on. There is nothing inherently better (or worse) for society in spending money on services as opposed to goods. Taxing goods but not services discriminates in favor of consumers who prefer services, and discriminates against those who prefer goods.

Expanding the sales tax base also makes the tax less regressive, because higher-income households spend more of their money on services while lower-income families primarily purchase goods. Of course, the sales tax will still be regressive overall no matter how broad the tax base is made. But taxing services can be an important step toward reducing sales tax regressivity.

Taxing services will also increase the amount of sales tax revenue collected at any given tax rate—which makes it less likely that lawmakers will be forced to raise the sales tax rate to balance budgets. And broadening the tax base makes sales tax revenues more stable in the long run, because declines in one area of taxable consumption will be offset by gains in another.

Should Internet transactions be taxed?

A growing share of retail purchases are now being made on the Internet—and are not being taxed by states. According to a recent study, the total state and local revenue loss from "e-commerce" was $15.5 billion in 2003.[4] The study projected that this revenue loss will reach $21.5 billion by 2008. Left unchecked, this revenue loss will sap the vitality of state sales taxes.

From a tax fairness perspective, Internet-based transactions should be treated in the same manner as other retail transactions. That is, retail transactions that are taxable when sold by Main Street retailers should also be taxable when sold over the Internet, for several reasons:

- Exempting e-commerce transactions is unfair to Main Street retailers. Retailers who choose to sell their wares primarily in a "bricks and mortar" setting rather than making sales over the Internet are unfairly disadvantaged by a policy that exempts e-commerce.
- Exempting e-commerce transactions is also unfair to consumers. Consumers who are unable to access the Internet are unfairly disadvantaged by having to pay sales taxes on their purchases. Exempting Internet retail sales probably increases the regressivity of sales taxes as better-off taxpayers are able to avoid these taxes through Internet purchases.

However, states are currently powerless to remedy this source of unfairness. A series of U.S. Supreme Court decisions, most recently *Quill v. North Dakota* (1992), have found that states cannot require retailers to collect sales taxes on items purchased from remote sellers (that is, sellers based in other states). As a rationale for this decision, the Court cited the complexity of state and local sales tax systems. The Court argued that with so many states, counties, and municipalities

[4]Donald Bruce and William Fox, "State and Local Sales Tax Revenue Losses from E-Commerce: Estimates as of July 2004" Center for Business and Economic Research, (Knoxville: Univ. of Tennessee) July 2004.

levying different taxes at different rates with different tax bases, forcing retailers to figure out the appropriate tax to collect on sales to each jurisdiction would impose an unacceptable administrative burden on these sellers.

However, the Court also indicated that this problem could be resolved, noting that there are good reasons to try to collect taxes on remote sales: even businesses that engage only in mail-order or Internet sales in a state still benefit from the public services that make these transactions possible—and should help to pay the cost of providing these services. The Court also noted that Congress could pass legislation allowing states to require sales tax collection on remote sales, and hinted that Congress would be more likely to pass such legislation if state lawmakers took immediate steps to simplify the current maze of tax bases and tax rates.

In recent years, states have responded to the Supreme Court's suggestion by cooperating to simplify their sales tax rules. The Streamlined Sales Tax Project (SSTP) was formed in April of 2000 by representatives of most states to develop a plan to simplify sales tax structures. In 2002, these representatives agreed on model legislation, called the Streamlined Sales and Use Tax Agreement (SSUTA), designed to be enacted by each state legislature. This legislation will become legally binding (in states enacting it) when 10 states representing 20 percent of the U.S. population enact it. However, even after this happens, the states will still be powerless to require the collection of sales taxes on remote sales until Congress acts to enable them. Although bills have recently been introduced in Congress that would allow states to collect sales tax on remote sales, these bills have so far failed to advance.

How Excise Taxes Work

Excise taxes are sales taxes that apply to particular products. Compared to sales, income and property taxes, excise taxes do not raise very much revenue. This is primarily because excise taxes lack a broad base, focusing instead on a narrow base of a few products—typically tobacco, fuel, and alcohol. Unlike general sales taxes, excise taxes usually are applied on a per-unit basis instead of as a percentage of the price. For instance, cigarette excise taxes are calculated in cents per pack. And most gasoline excise taxes are imposed in cents per gallon.

Because excise taxes are generally not itemized on consumer receipts, they tend to be invisible to the taxpayer. In the case of gasoline taxes, some states have one tax when fuel enters the state and another that is applied at the pump. New York, for example, has what appears to be one of the lowest state gasoline tax rates at only 8 cents per gallon. But after adding in the Petroleum Testing Fee, the Petroleum Business Tax, the Supplemental Business Tax and the Oil Spill Cleanup and Removal Tax, however, the New York tax that shows up in the pump price is around 32 cents per gallon. Consumers don't see these taxes in the price—but they're still there.

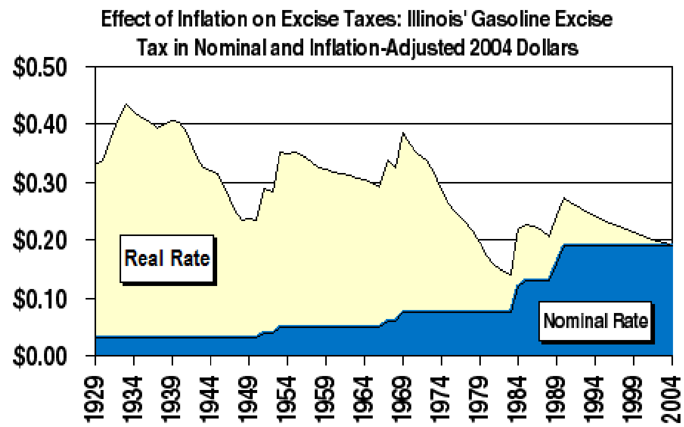
Excise Taxes Are Regressive

Like sales taxes, excise taxes apply to purchases that take more of the income of middle- and low-income families than of the rich. But excise taxes are usually even more regressive than general sales taxes.

With a sales tax, the tax is at least related to the price of the thing purchased. So the sales tax paid on a wealthy person's Mercedes is more—in dollars—than the tax on a middle-income family's Chevrolet. But because excise taxes are usually calculated on a per-unit basis, it doesn't matter that rich people often buy more expensive things. The tax is the same on premium wine and beer as on less expensive brands. Moreover, there are natural limits on what can be spent on most items subject to excise taxes. Rich people typically don't drive more in a year than do middle-income families, so their gasoline tax bills are almost the same in absolute dollars. As a result, the share of income spent by the wealthy on excise taxes is particularly low.

A Slow-growth Tax

Excise tax revenues tend to grow very slowly, which makes them an inadequate source of revenue over the long run. The per-unit base of excise taxes means that these taxes inherently grow more slowly than the economy. Excise tax revenue grows only when the volume of the commodity sold grows, and does not respond to changes in prices. In an inflationary environment, this means that states must continually raise the rates of excise taxes just to keep revenues up with inflation. The chart at right shows the legal rate and the inflation-adjusted rate of Illinois' gasoline excise tax over time.



No Federal Deductibility

Excise taxes are not deductible in computing federal taxable income. As a result, every dollar paid by residents of a state in excise taxes is a dollar out of their pockets. There is no offsetting reduction in federal income taxes for those who itemize deductions.

"Sin" Taxes

A **sin tax** is a tax (almost always an excise tax) levied on a good or service that is deemed to be in some way detrimental to society—typically products such as alcohol, cigarettes, and gasoline. Proponents of sin taxes argue that these taxes are good because they discourage a particular behavior—smoking, for example, or driving gas-guzzling cars—by raising the price of the product. If the tax is imposed *for the express purpose* of affecting behavior rather than raising revenue, the tax may be successful. However, many policy makers cloak their desire for a revenue generator with these arguments, and as a revenue generator, a sin tax is inherently flawed.

Most revenue sources are expected to grow with inflation and an increasing population; most sin taxes, however, are a naturally *decreasing* source of funding. As the tax increases, consumption —and revenues—will decrease. Many states are using these revenues to support programs, such as education or health programs, that have a naturally increasing need for funding. The result is that, while sin taxes may bring in enough revenue to support the designated program for a few years, in the long run a deficit will inevitably appear unless the taxes are raised yet again.

Excise Tax Issues

Excise taxes are inherently regressive. In some cases, however, a slight improvement can be made by making an excise tax apply to the value of the goods taxed instead of basing it on the number of units purchased. For instance, having a 4 percent tax on the value of liquor is somewhat less regressive than a 60 cents per-bottle tax. With the 4 percent tax, the amount due would be 40 cents on a $10 bottle of liquor and $1.20 on a $30 bottle. Thus, those who can afford more expensive brands will pay more, in dollar terms. Of course, as a share of income the tax will still be very regressive—but less so than if the tax is a flat amount per bottle.

Some states have tried to improve upon the gasoline excise tax by enacting a variable tax rate, indexing the rate for inflation. Wisconsin, for example, adjusts its gas tax rate every April based on the U.S. Consumer Price Index. Six other states also tax gasoline on a variable basis.

CHAPTER FOUR
PROPERTY TAXES

The property tax is the oldest major revenue source for state and local governments. At the beginning of the twentieth century, property taxes represented more than eighty percent of state and local tax revenue. While this share has diminished over time as states have introduced sales and income taxes, the property tax remains an important mechanism for funding education. But property taxes are regressive, and because these taxes are usually collected at the local level, the unequal distribution of wealth between rich and poor school districts can lead to inequitable school funding. The challenge facing state lawmakers today is to preserve this important revenue source while making the tax less regressive, and reducing the disparities in school funding between rich and poor districts. This chapter surveys the basic workings of the property tax, and assesses its weaknesses and strengths.

The Property Tax: How it Works

Historically, property taxes applied to two kind of property: **real property**, which includes land and buildings, and **personal property**, which includes moveable items such as cars, boats and the value of stocks and bonds. Most states have moved away from taxing personal property and now impose tax primarily on real property. In its simplest form, the real property tax is calculated by multiplying the value of land and buildings by the tax rate. Property tax rates are normally expressed in **mills**. A mill is one-tenth of one percent. In the most basic system, an owner of a property worth $100,000 that is subject to a 25 mill (that is, 2.5 percent) tax rate would pay $2,500 in property taxes.

In reality, however, property taxes are often more complicated than this. The first step in the property tax process is determining a property's value for tax purposes. This means estimating the property's **market value**, the amount the property would likely sell for. The second step is determining the property's **assessed value**, its value for tax purposes. This is done by multiplying the property's market value by an **assessment ratio**, which is a percentage ranging from zero to one hundred. Many states base their taxes upon actual market value—in other words, these states use a 100 percent assessment ratio.

But many states assess property at only a fraction of its actual value. New Mexico assesses homes at 33.3 percent of their market value, and Arkansas uses a 20 percent assessment ratio. And even when the law says properties should be assessed at 100 percent of their value, local assessors often systematically under-assess property, reporting assessed values that are substantially less than the real market value of the property.

Effective versus Nominal Rates—An Example

Here's an example of why it's important to look at effective tax rates instead of nominal rates. Property tax assessments vary greatly between localities, with some places assessing property at only a fraction of its real value. So some localities are applying their tax to a broader base than others.

By only comparing nominal rates, one might conclude from the example below that Town A has higher property taxes than Town B. But by looking at effective tax rates we see that the property tax burdens are, in fact, equal. Effective rates take into account the different assessment practices in Town A and Town B. (Town A assesses at 50 percent of market value, Town B at 100 percent).

Calculation of Property Tax	Town A	Town B
1. Nominal Tax Rate	3%	1.5%
2. Real Market Value	$100,000	$100,000
3. Assessed Value	$50,000	$100,000
4. Tax (line 3 times line 1)	$1,500	$1,500
5. Effective Rate on Market Value (line 4 divided by line 2)	**1.5%**	**1.5%**

Many states reduce a property's assessed value further by allowing exemptions. For example, Florida allows an exemption for the first $25,000 of home value. Subtracting all exemptions yields the **taxable value** of a property.

The next step in the process is applying a property tax rate, also known as a **millage rate**, to the property's taxable value. The millage rate is usually the sum of several tax rates applied by several different jurisdictions: for example, one property might be subject to a municipal tax, a county tax, and a school district tax. This calculation yields the property tax owed.

The rate most property owners are familiar with is the nominal rate—the actual tax rate used in calculating your bill. But when comparing property taxes across districts or across states, analysts will often look at effective property tax rates, which are usually calculated by expressing the property tax as a share of market value. Expressing property taxes this way gives us a better sense of how all exemptions and assessment ratios affect the tax paid.

Many states allow property tax credits that either directly reduce the property tax bill, or that reimburse part of the property tax bill separately when taxpayers apply for them. These property tax relief mechanisms are described later in this chapter.

A Regressive Tax

Although sales and excise taxes are the most regressive taxes, they are rarely as maligned as the property tax. The "sticker shock" effect of the property tax is partly to blame for this: it's a large, very noticeable payment that is made once or twice a year, while sales taxes are spread throughout the year on hundreds of purchases. So the property tax often seems more oppressive and more unfair than it actually is, simply because it's more visible.

That said, there is no denying that the property tax is generally regressive. Nationwide, low-income families paid 3.0 percent of their income in property taxes in 2002, while middle-income families paid 2.4 percent of their income and the wealthiest taxpayers paid just 0.8 percent.

The chief reason that property taxes are regressive is that they are based on home values rather than on income levels—and home values do not always vary directly with income levels. Home values represent a much larger share of income for middle- and lower-income families than for the wealthy. For example, it is common for a middle-income family to own a home valued at two or three times their annual income, but wealthier taxpayers are less likely to own homes worth as much relative to their income levels.

Moreover, property taxes are not responsive to variations in taxpayers' income: someone who suddenly loses his job will find that his property tax bill is unchanged, even though his ability to pay it has drastically fallen. (By contrast, income tax bills depend on the level of earned income, so income taxes are much more sensitive to taxpayers' ability to pay—an important consideration in times of economic hardship.) And the property tax can be especially burdensome for elderly taxpayers at the end of their working careers who find themselves "property rich" but "cash poor."

Who Bears the Brunt of Taxes on Homes?

Is it...

Warren Buffett, of Omaha, Nebraska--One of the 400 Richest Americans?*	
Net Worth	$36 billion
Taxable Value of Home	$690,300
Home Value as % of Net Worth	0.002%
Tax as % of Net Worth	**0.00004%**

*"400 Richest in America," Forbes, 2003; Omaha World Herald, 8/22/03

Or is it...

Susan Anybody, a Hypothetical Middle-Income Homeowner?	
Net Worth:	$80,000
Taxable Value of Home	$50,000
Home Value as % of Net Worth	62.5%
Tax as % of Net Worth	**1.3%**

When the United States was an agrarian society, the property tax was a fair form of taxation. The value of a citizen's land and buildings was an excellent measure of her wealth. But today, rich families have most of their wealth in other forms of property—stocks, bonds, etc. These forms of property are usually not taxed. According to one recent study, in 2001 real estate represented less than twenty percent of the assets of the richest 0.5 percent of wealth-holders.[5]

Low- and middle-income families, however, still have most of their limited wealth invested in their homes. Because the wealthy have relatively little of their wealth invested in property subject to the real property tax, while the most valuable thing a middle-income family owns is its house, much more of a middle-income family's wealth is subject to the property tax.

Business Property Taxes

Of course, homeowners don't pay all of the property tax. Businesses pay it as well. Property taxes on business are mostly borne by business owners. (The special case of residential rental property is discussed below.) This makes the property tax less regressive since business owners tend to be wealthier than average. Also, some of the business property tax is exported to property owners living in other communities and other states. The business property tax is important because without it, many businesses that use local government services would go largely untaxed.

Residential Rental Property

While the public's attention to property taxes is usually focused on the taxes paid by homeowners, the property tax also affects taxpayers who rent, rather than own, their home. Who ultimately pays the property taxes on residential rental real properties is disputed. Some economists believe that it is mostly borne by the landlords who own these rental properties. Others argue that it is mostly passed through to tenants in the form of higher rents. It is generally agreed that the answer partially depends on the rental market. When residential rental property is in short supply, landlords are more likely to pass their property taxes on to renters in the form of higher rents. But if rental property is abundant, landlords may find this more difficult.

Of course, most rental markets are not purely dominated by either tenants or landlords—so the answer probably is somewhere in between. And the matter is confused further because many rental markets cross municipal boundaries so that taxes vary on rental units in different parts of the market. Landlords in higher tax jurisdictions can't simply raise rents to pay their property taxes if they have to compete with apartments in nearby, lower tax jurisdictions.

Two things are certain about property taxes on rental property. First, owners lobby against property tax hikes as if they think owners pay the tax, but when they try to raise rents they tell their tenants that tenants have to pay it. Second, because renters as a class are poorer than homeowners, "property tax relief" (discussed below) paid directly to renters is progressive regardless of whether the relief really is related to tenants' actual property tax burdens.

Personal Property Taxes

Personal property is all property other than real estate. Personal property taxes usually apply to **tangible** property such as individually-owned cars and trucks or business equipment. The tax can also apply to **intangible** property such as stocks and bonds.

Taxing tangible personal property is relatively straightforward, in theory. In the case of cars and trucks, the tax is usually a percentage of the "blue book" value of the vehicle. Since people

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[5]Arthur Kennickell, "A Rolling Tide: Changes in the Distribution of Wealth in the US, 1989-2001", November 2003. Levy Economics Institute Working Paper No. 393.

have to register their vehicles, it's hard to avoid the tax. And business equipment can be assessed based on income tax return data for depreciation deductions.

The most common type of state personal property tax is on individually-owned cars and trucks. Although at first glance this tax may appear to be progressive (rich people have more expensive cars), it is not. Personal property taxes on automobiles are regressive for the same reason residential property taxes are regressive: the value of a person's car (or home), as a share of their income, is higher for low-income people than for the wealthy.

On the other hand, business personal property taxes and, especially, intangible property taxes on stocks and bonds are progressive because the wealthy own far more business property and intangible assets than do middle- and low-income people. It's also easy to exempt low- and middle-income people from an intangible property tax by providing generous exemptions.

Unfortunately, taxation of intangibles is hard to enforce because of the difficulty in valuing many taxable stocks and bonds and the ease of hiding many intangible assets. If these problems can be solved, however, an intangibles tax is extremely progressive, and can be a substantial revenue raiser, even with very low rates.

Florida raised $717 million in 2001 from its intangibles tax. Enforcement is, however, largely confined to intangibles for which income is reported on the federal income tax. It is widely believed that there is a significant compliance problem in Florida—with much of the intangible wealth of rich Floridians escaping taxation.

Revenue and Stability

Property taxes are generally more stable over time than the income or sales tax. This is because property tax revenue depends on property values, not income. When personal income grows rapidly, property taxes will generally not grow as fast—and slower personal income growth is not always reflected in slow property tax growth. If property values are inflated prior to a recession, they will tend to fall once a recession starts. If an area is particularly hard hit by an economic downturn—if a town loses its leading industry, for example—property values also probably will fall. On the other hand, where property values were not inflated and a downturn is not catastrophic, it is not uncommon for property values to hold relatively steady during a recession.

Unfortunately, property tax stability also means that people who are hardest hit during a recession—people who lose their jobs—don't get any relief. Property taxes are insensitive to variations in taxpayers' income: a taxpayer who suddenly becomes unemployed will find that her property tax bill is unchanged, even though her ability to pay it has fallen. By contrast, income taxes vary with income, so income taxes are more sensitive to taxpayers' ability to pay.

Deductible in Computing Federal Income Tax

Property taxes, like state and local income taxes, are deductible in calculating federal taxable income (for those who itemize their returns.) This means, in effect, that a portion of a state resident's property tax bill is "exported" to the federal government in the form of reduced federal income tax for itemizers, and never comes out of the pocket of state residents.

Because property taxes are much more regressive than income taxes, the lion's share of these taxes are paid by low- and middle-income taxpayers who are less likely to itemize. This means that property taxes offer a lower "bang for the buck" than income taxes in terms of the federal offset.

Car taxes are deductible, but only when they are calculated as a percentage of the car's value. Car taxes that are based on a flat dollar amount cannot be deducted. This is an important consideration because almost all states levy flat-dollar car "registration fees" that cannot be deducted.

Property Tax Relief Options

As states have moved away from heavy reliance on property taxes, a variety of different mechanisms have been introduced for providing residential tax relief. This section surveys various approaches to property tax relief, including general exemptions, targeted low-income tax credits, "split roll" taxes and income tax-based deductions and credits.

Homestead Exemptions

More than forty states now allow some form of a **homestead exemption**, which reduces property taxes for all homeowners by sheltering a certain amount of a home's value from tax. Homestead exemptions are a progressive approach to property tax relief, providing the largest tax cuts as a share of income to lower- and middle-income taxpayers.

There are two broad types of homestead exemptions: flat dollar and percentage exemptions. Flat dollar exemptions are calculated by exempting a specified dollar amount from the value of a home before a property tax rate is applied. A flat dollar exemption is especially beneficial to low-income homeowners, because it represents a larger share of property taxes (and of income) for low-income taxpayers. Percentage exemptions give the same percentage tax cut to all income levels. This form of exemption is also progressive—but is less effective at targeting relief to poor taxpayers than are flat exemptions.

The table at right illustrates this point using two examples. If the state allows a flat exemption for the first $15,000 of home value, a home worth $60,000 will see a 25 percent property tax cut. A home worth $500,000, however, will only see a 3 percent property tax cut. By contrast, a percent exemption will give each taxpayer the same percentage cut.

Flat Dollar versus Percentage Exemptions: Who Benefits?
[Calculation Assumes 20 Mil (2 percent) Rate]

Assessed Home Value	$60,000	$500,000
Tax Without Exemption	$1,200	$10,000
Flat $ Exemption	*$15,000*	*$15,000*
New Taxable Value	$45,000	$485,000
Tax With $ Exemption	$900	$9,700
Tax Cut	**25%**	**3%**
Percent Exemption	*15%*	*15%*
Exemption in $	$9,000	$75,000
New Taxable Value	$51,000	$425,000
Tax With % Exemption	$1,020	$8,500
Tax Cut	**15%**	**15%**

Fixed dollar exemptions tend to become less valuable over time. In Florida, for example, the average home value jumped from $88,000 in 1998 to $140,000 in 2003—a 59 percent increase in only five years. But during that time, the value of Florida's homestead exemption remained at $25,000. So for most Florida homeowners, the exemption is now a much smaller portion of their home value than it was in 1998. Indexing exemptions (that is, automatically increasing the exemption every year to take account of the rising cost of living) can avoid this unintentional tax hike.

While homestead exemptions are a progressive approach to property tax relief, they have two important flaws: first, they provide no tax relief to renters, even though renters are generally agreed to pay some property tax indirectly in the form of higher rents. Second, exemptions are poorly targeted and costly. Because most homestead exemptions are not targeted to low- and middle-income taxpayers, but are available to even the wealthiest homeowners, they are especially costly—and provide little "bang for the buck" to low-income taxpayers.

Circuit Breakers

The property tax **circuit breaker** is a less expensive, more targeted approach to tax relief. Its name reflects its design. Because it protects low-income residents from a property tax "overload" just like an electric circuit breaker: when a property tax bill exceeds a certain percentage of a taxpayer's income, the circuit breaker reduces property taxes in excess of this "overload" level.

Circuit breakers usually give homeowners a credit equal to the amount by which their property tax bill exceeds a certain percentage of their income, though there is usually a cap

limiting the total amount of credit allowed. Circuit breakers are usually made available only to low-income taxpayers, on the theory that property taxes are most burdensome for the least wealthy homeowners. Because it is generally agreed that renters pay property tax indirectly in the form of higher rents, many states now extend their circuit breaker credit to renters as well. The calculation is the same as for a homeowner, except that some percentage of the rent you pay is assumed to be the property tax paid. Renters in Michigan, for instance, use 20 percent of their rent as their assumed property tax in calculating their circuit breaker credit.

The ability to target circuit breakers to those taxpayers most in need means that virtually none of the property tax relief from a circuit breaker credit will be offset by federal income tax hikes for itemizers. By contrast, when a homestead exemption reduces the property tax paid by a wealthy homeowner, that homeowner will have less property tax to claim as an itemized deduction on his federal tax return—which means that his federal taxes will go up.

Like the homestead exemption, circuit breakers must be indexed for inflation in order to preserve the value of this tax break for low-income taxpayers. For example, if the Illinois circuit breaker's maximum income level for eligibility and the maximum credit amount had been indexed for inflation since it was first introduced in 1972, the income threshold would have been $45,000 in tax year 2004—more than double the current value for unmarried taxpayers—and the maximum value of the credit would have been more than four times its current value.

The main drawback of circuit breakers is that, in general, they only are given to taxpayers who apply for them. (By contrast, homestead exemptions are usually given automatically to eligible taxpayers.) Eligible taxpayers will only apply for tax credits if they are aware of their existence. This means that an essential component of a circuit breaker program must be an educational outreach effort designed to inform state taxpayers of the credit. In addition, one way of making it easier for eligible taxpayers to claim the circuit breaker is to make it possible to claim the credit either on income tax forms or on a separate circuit breaker form (for those who do not have to file income tax forms).

Split Roll

A third way to provide progressive property tax relief is a split roll, also known as a "classified property tax." Unlike a regular property tax, which taxes the value of all real property at the same rate, a split roll property tax applies different effective tax rates to different types of property. One approach to a split roll property tax is taken by the District of Columbia, which taxes homes at a lower rate than business properties. This shifts some of the property tax burden from homeowners to businesses. The chart on this page shows the current tax rates in the District of Columbia.

District of Columbia Split Roll Property Tax Rates, 2004

Class	Tax Rate (in Mils)	Description
I	9.6	Residential
II	18.5	Commercial
III	50	Vacant

A second approach is to assess homeowners at a lower percentage of their value than other types of property. For example, Utah assesses all residential properties at 55 percent of their value, and assesses all other types of property at 100 percent of their value. A single tax rate is then applied to all properties of all types within each taxing district. This approach has exactly the same impact on tax fairness as the District of Columbia approach of using different tax rates.

Split roll taxation has three main shortcomings. First, it's poorly targeted. Every homeowner pays a lower tax rate because of the split roll, from the very poorest to the very wealthiest. And the lower rate is available to anyone who owns a property—even those whose principal residence is in another state. A better-targeted approach would provide tax cuts only for the low- and middle-income homeowners for whom these taxes are most burdensome. Second, reducing the property tax on one class of property inevitably means shifting a greater share of the tax onto other groups. Unless lawmakers ensure that the "residential" property tax owner includes renters

as well as homeowners, split roll taxation can actually make the property tax less fair by shifting the property tax burden from homeowners to low-income renters. [6] Third, the split roll makes property tax administration more complicated, because it requires tax administrators to determine not just the value of each property, but also its use.

Income Tax Breaks for Property Taxes

Most states provide property tax relief through their income tax forms. This is done in two ways: itemized deductions and income tax credits. More than thirty states allow itemizers to deduct their property tax payments from their taxable income. Since these deductions are usually only available to state itemizers—and can only be claimed by those who pay state income taxes—this approach to property tax relief excludes many of the low-income homeowners for whom property taxes are most burdensome.

A few states provide other forms of income-tax-based property tax relief. Illinois, for example, allows taxpayers to claim a non-refundable income tax credit equal to 5 percent of the property taxes paid on their home. Credits are usually a more progressive approach to tax relief—but when these credits are non-refundable, those who don't pay enough income tax to claim the full credit receive less relief, despite the fact that these "income-poor, property-wealthy" taxpayers are often less able to pay property taxes than most.

Property Tax Issues

Property taxes are the most venerable revenue source for state and local governments—but there is some concern that these taxes are unsuitable for the needs of the modern state. This section looks at two such areas of concern: the impact of regional inequities in property wealth on the quality of public education in poor districts, and the quality of property tax assessment.

Property Taxes and Education Financing

The primary purpose of local property taxes is to fund schools. But property wealth is usually distributed unequally between taxing districts. As a result, property-poor districts are not able to fund education as easily as property-wealthy districts. For example, in 2000 the Lake View school district in Arkansas raised only $827 per student in local revenue—just over a quarter of the $3,200 per student raised by the much wealthier Little Rock school district in that year. Left to their own devices, low-wealth districts typically have to tax homeowners at a much higher rate—and still don't raise as much revenue per-pupil as a wealthier district can. This sort of inequity between poor and wealthy districts has been the basis for a series of court cases challenging the constitutionality of school funding systems in various states.

Even property-wealthy districts can find it difficult to raise enough money to fund schools adequately using property taxes. As a result, almost every state has enacted a program of state aid to local school districts, designed to provide a guaranteed minimum amount of education spending per pupil while minimizing the gaps in spending between poor and wealthy districts.

What can go wrong with a school funding system that works in this way? First, the baseline amount of spending per pupil may be well short of the amount required to achieve an adequate education—that is, states can achieve equity without achieving adequacy. Second, property-wealthy districts can usually raise *more* than this state-sponsored amount per pupil without relying on state help—which means that the amount spent on education will differ between poor and wealthy districts, even after taking account of state aid. Some argue that as long as these differences between poor and wealthy districts remain, equity will not have been achieved.

[6] This was originally true of the D.C. split roll system. Until quite recently, homeowners paid a tax rate of 0.96 percent and rental properties paid 1.54 percent. But tax changes enacted in 1999 reduced the property tax rate on residential rental real estate to equal the homeowner rate.

One tax reform option for the growing number of states that are now confronting court mandates to fund schools adequately and equitably is to preserve the role of property taxes in funding schools by replacing some of their current local property taxes with a statewide property tax levied at a uniform rate. The statewide property tax requires the same level of effort from all taxing districts in a state, and reallocates some of the resulting tax revenue between wealthy and poor districts in a way that equalizes the revenue-raising ability of all districts.

Assessment Practices

The most important step in the property tax process is assessing the value of a property. After all, home value is the basis for measuring a homeowner's ability to pay—so the property tax will only be as fair as the assessment process. Unfortunately, many jurisdictions don't assess property fairly. Some states don't require regular reassessment of property. In other states, there can be significant variation in assessed values between properties that are actually very similar. When assessment practices are poor, two families with identical homes and the same income level could face different property tax bills. This undermines people's faith in the fairness of the tax system and erodes public support for the taxes needed to pay for government services.

Local assessors routinely assess properties at less than what the law prescribes. For example, a typical state might require that residential properties be assessed at 100 percent of their market value, but assessors might actually assess these properties at an average of 90 percent of their market value. From a tax collector's point of view, this approach has two virtues. First, it gives taxpayers the illusion that government is giving them a good deal by taxing only part of their home values. This is an illusion because the underassessment, by necessity, is offset by a higher property tax rate. Second, underassessment reduces the likelihood of legal challenges to assessments. Unless homeowners compare their assessments with those of other homeowners, even large and unfair discrepancies will not be detected.

When property is under-assessed not because of poor-quality assessments but because of legal rules requiring low assessment ratios, fairness can be undermined as well. If assessments are at full value, inaccurate assessments stand out. But if property is legally assessed at (for example) 20 percent of its true value, it becomes much harder to detect variations in assessment quality because the assessed value is hard to compare to a homeowner's sense of the home's true value. Thus, underassessment makes unfair or corrupt assessment practices more difficult to detect.

Poor or infrequent assessment can also make it difficult for lawmakers to equalize differences between poor and wealthy districts' ability to fund schools. Most state school-aid programs are based on the property wealth of each district—and poor-quality assessments make it hard to know which districts are truly poor and which are simply under-reporting their assessed value. For this reason, reform of local property assessment practices must usually be done before school finance reform can be accomplished at the state level.

Important steps lawmakers can take to ensure transparency in the property assessment process include:

- Hiring and training professional assessors;
- Making assessed valuation information publicly available;
- Assessing property at its full value so taxpayers can understand how they are being taxed.

Conclusion

Property taxes are generally regressive, and relying on local property taxes to fund education can create unfair disparities between poor and wealthy districts. But the property tax plays an important role in funding public services, and progressive tax reform can help make the tax a sustainable—and less unfair—revenue source for the twenty-first century.

CHAPTER FIVE
PERSONAL INCOME TAXES

The **personal income tax** can be—and usually is—the fairest tax. When properly structured, it makes wealthier taxpayers pay their fair share, eases the tax load somewhat on middle-income families and completely exempts the poor. Because the personal income tax is the only major progressive tax levied by states, it provides an important counterbalance to regressive sales, excise and property taxes.

But in many states, the income tax fails to live up to its potential. Some states have flat tax rates, while others tax at least some of the income of families living in poverty. And many states allow expensive, poorly targeted tax breaks that favor wealthier taxpayers. This chapter explains the basic workings of the income tax and discusses important issues that should be addressed in order to ensure the continued fairness and adequacy of this tax.

How It Works

Almost all states with personal income taxes tie their income tax base to federal tax rules. This means that income taxpayers can do their federal income taxes and then copy their total income from the federal tax forms to their state tax form. This time-saving step makes income taxes easier to file—and makes it easier for tax administrators to monitor compliance. Most states link to federal adjusted gross income (AGI), which is income before exemptions and deductions, and then allow their own special exemptions and deductions. A few states link to federal taxable income, which already includes the generous federal exemptions and deductions, and then apply their own tax rates. A few states do not link to the federal tax base at all.

Which Income is Taxed—and Which Is Exempt?

The federal income tax and most state income taxes apply to most, but not all, types of money income.[7] But different types of income are, in some systems, taxed differently:

- **Wages and salaries** are almost always taxed. However, "fringe benefits" such as employer-paid health insurance are usually tax-exempt, and taxes on employer contributions to pension plans are deferred until the money is paid out at retirement.
- **Interest** from bank accounts and bonds is generally taxed. A few states, however, exempt some interest. For example, Massachusetts excludes the first $100 ($200 for a married couple) of interest received from Massachusetts banks. Interest from government bonds usually gets preferential treatment: interest from federal treasury bonds is exempt from state taxation, and interest from state and municipal bonds is exempt from the federal tax. States often exempt interest on their own bonds, while taxing other states' bonds.
- **Business income or loss** for individuals is the taxable profit (or loss) from unincorporated businesses. People who are self-employed report their taxable business results on Schedule C. For example, if someone makes and sells furniture, he or she reports the gross proceeds from selling the furniture minus deductible expenses such as the cost of wood, tools and advertising. Partnership income is reported similarly: each partner reports his or her share of taxable partnership profit or loss on Schedule E. Farm profits and losses are reported on Schedule F. Because of a variety of special tax concessions for farming, most people filing farm tax returns claim "losses" rather than profits for tax purposes.

[7]New Hampshire and Tennessee tax only interest and dividend income, and half a dozen states have local income taxes that apply only to wages.

From 1988 to 2002, taxable farm profits reported to the IRS were $138 billion, but tax-deductible losses totaled $223 billion.

- **Rental income** is reported on a separate form on federal tax returns. Gross rents are offset by various expenses. One "expense" that is commonly used to reduce taxable rental income is "depreciation." For tax purposes, rental real estate is assumed to gradually lose its value, or depreciate, over time. (Of course, this is usually a fiction—rental real estate typically becomes more valuable over time.) For some real estate professionals (broadly defined), depreciation expenses can be used to reduce not just rental income but other income as well. But for most people, depreciation can only reduce taxable rental income. This makes it less attractive for people to invest in real estate solely as a tax shelter—a widespread tax-avoidance scheme before 1986 federal legislation narrowed this loophole.
- **Capital gains** are profits from the sale of assets such as stocks, bonds and real estate. Income tax on a capital gain is paid only when the asset is sold. Thus, a stockholder who owns a stock over many years doesn't pay any tax as it increases in value each year. He or she pays tax only when the stock is sold. At that time, the capital gain is calculated by taking the difference between the original buying price and the selling price.[8] The federal government now taxes capital gains at a far lower rate than wages. A few states also provide capital-gains tax breaks. State capital-gains tax breaks are discussed on page 34.
- **Dividends** are the part of a corporation's earnings that are distributed to its shareholders. Until 1986, the first $100 ($200 for married couples) of dividends was exempt from the federal personal income tax. From 1986 to 2002, dividends were taxed as regular income. The 2003 Bush tax cuts created a special set of lower tax rates for dividend income. A few states allow special dividend exclusions of their own.
- **Transfer payments**, such as welfare benefits, unemployment compensation and Social Security benefits are subject to a variety of different rules. The federal income tax exempts welfare, treats unemployment compensation the same as wages and taxes a fraction of Social Security benefits above certain income levels. A few states follow the federal rule and tax some Social Security benefits, but most states completely exempt Social Security.
- **Pension income** is generally taxable at the federal level, with an offset for already-taxed employee contributions to pension plans. Many states exclude all or some government pension income from taxation, and some even exempt private pension income. Some states provide targeted pension tax relief, available only to lower-income taxpayers.

"Adjustments" and Adjusted Gross Income

Once all of a taxpayer's taxable income is added up, **adjustments to income** are subtracted. Some adjustments appear on federal tax forms—and most states following federal rules will include these adjustments, too. For example, contributions to retirement accounts by self-employed people are subtracted from total income as an adjustment on federal forms, and most states have chosen to conform to federal rules by allowing the same tax break. Other examples of typical adjustments are alimony and health insurance payments by the self-employed. On federal forms, **adjusted gross income** is the income that is subject to tax after subtracting these adjustments.

In addition to these federal adjustments, most states diverge from the federal starting point to allow at least one special deduction or targeted tax break of their own invention. These special

[8]People who inherit property don't pay income tax on capital gains that accrued during the original owner's life. If Sally Jones buys stock in 1990 worth $1,000, then dies in 2000 with it having a value of $10,000, no income tax is ever paid on the $9,000 of gain from 1990 to 2000. If her heirs sell the stock in 2002 for $12,000, the heirs pay tax on only the $2,000 gain from 2000 (the date of inheritance) to 2002.

breaks are the difference between the federal starting point (usually federal AGI) and a state's own adjusted gross income. Among the tax breaks commonly granted by states are:

- Exemptions for capital gains or dividends;
- Tax shelters for pension or Social Security benefits;
- Deductions for federal income taxes paid.

Every special state tax break has to be subtracted from income—which means it takes at least one line on your state's tax form. The main reason why state income tax forms—and instructions—are so complicated is because taxpayers must wade through these special tax breaks.

When these tax breaks discriminate between taxpayers who have a similar ability to pay, such unfair distinctions can make the tax system seem more arbitrary—and can undermine public confidence in the system. These tax breaks also make it harder to understand the overall effect of a tax system on people at different income levels.

Computing Taxable Income

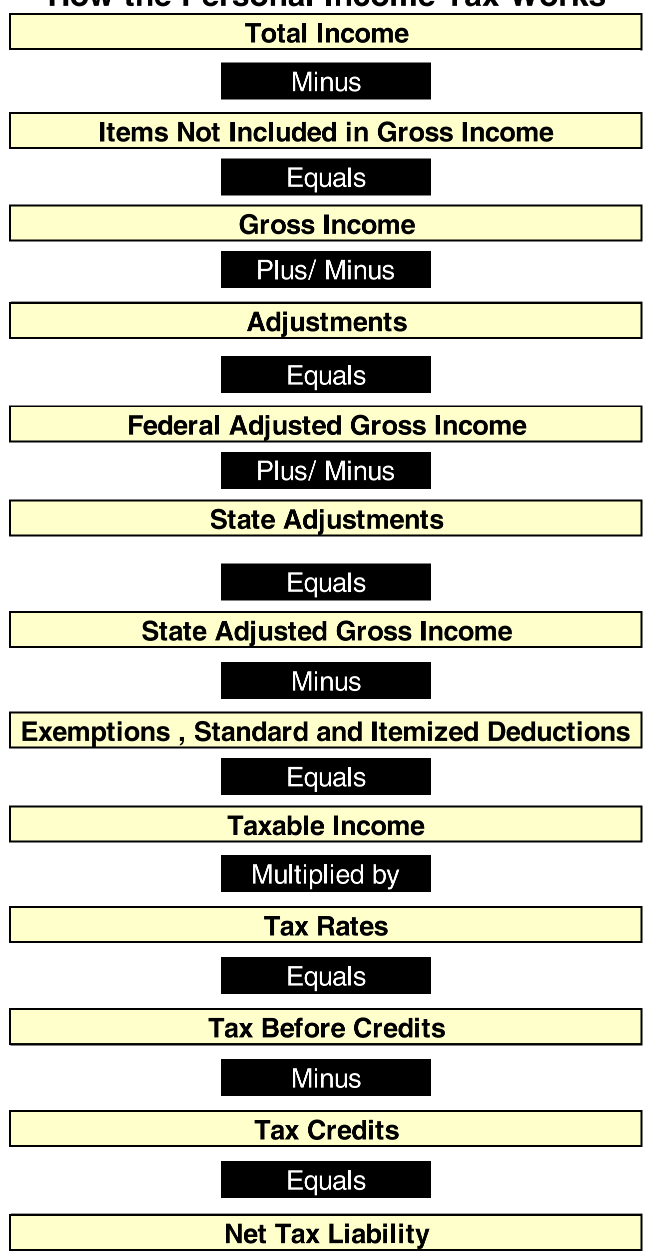
Taxable income is the amount of income that is subject to tax after subtracting deductions and exemptions from AGI. This is the amount to which the income tax rate(s) are applied.

In computing their taxable income, taxpayers usually have a choice of subtracting from AGI either a standard deduction or their total itemized deductions—whichever is larger. Generally, better-off families are more likely than lower-income families to have enough deductions to make itemizing worthwhile. Deductions related to homeownership are often what makes a family's itemized deductions exceed its standard deduction.

Itemized deductions are allowed for two main reasons. Usually the primary reason is to take account of large or unusual personal expenditures that affect a taxpayer's ability to pay. Itemized deductions are also offered as a way of encouraging certain types of behavior. For example, on the federal income tax return:

- Charitable contributions are deductible to encourage charitable giving, and because people who give income to charities have less money left over with which to pay income taxes.
- Mortgage interest paid by homeowners is deductible to encourage home ownership, and because the interest paid on mortgages is one of the principal costs associated with owning a home.
- State and local income and property taxes are deductible on the federal level because families that pay a lot in those taxes have less ability to pay federal income taxes than those who pay little. (By con-

How the Personal Income Tax Works



trast, most states don't allow a deduction for their own income taxes, but do allow a deduction for property taxes.) Sales and excise taxes are generally not deductible, however, because Congress found that (a) they don't affect ability to pay very much for those who itemize, (b) they are difficult for taxpayers to compute and hard for tax agencies to audit, and (c) since they are regressive, states shouldn't be encouraged to rely too heavily on them. (Federal legislation in 2004 allows an optional, temporary deduction for sales taxes paid on 2004 and 2005 federal tax forms, but taxpayers claiming the deduction cannot write off their state and local income taxes—which means that this temporary deduction will generally only be useful—very modestly—for residents of non-income tax states.)

- Very large medical expenses are deductible to reflect taxpayers' reduced ability to pay taxes under adverse medical circumstances. At the federal level and in most states, medical expenses that exceed 7.5 percent of a taxpayer's adjusted gross income are deductible.

A **standard deduction** is a basic zero-tax amount, used by people whose itemized deductions total less than the standard deduction amount. The theory behind a standard deduction is that even those who do not have significant itemized deductions have a certain amount of income that should not be subject to tax.

On federal returns, the standard deduction is set at $9,700 for couples, $7,150 for unmarried parents and $4,850 for single filers in 2004. (These amounts are increased every year to allow for inflation.) Twelve states allow the same standard deductions as the federal amounts; three allow larger amounts; and the rest have smaller standard deductions or don't allow one at all.

The final step in arriving at taxable income—the tax base to which income tax rates are applied—is to subtract **personal exemptions**.

At the federal level, the personal exemption is currently $3,100 for each taxpayer and dependent (indexed each year for inflation). Thus, in 2004 a family of four gets a total of $12,400 in federal exemptions. State personal exemptions vary greatly, but are usually less generous than the federal amounts. Some states provide additional exemptions for the elderly, disabled or veterans.

The theory behind exemptions is that at any income level, a taxpayer's ability to pay declines as family size increases: the more mouths to feed, the less money is left over to pay taxes. So if two families each make $40,000 and family A has no children while family B has two, then family A has greater ability to pay. To adjust for this, family B gets two more exemptions than family A.

Some states tie their exemptions to the federal amount. Because federal exemptions grow each year with inflation, this is an administratively easy way to ensure that exemptions will not lose their value over time. States that fail to adjust their exemptions for inflation will end up imposing a hidden tax hike on their citizens over time. For instance, when the Illinois income tax was adopted in 1969, the state's personal exemption was set at $1,000—and was subsequently left unchanged for thirty years. 1998 legislation doubled the exemption to $2,000—but if the exemption had been kept up with inflation since 1969, it would currently be worth $5,100. In other words, the Illinois personal exemption is worth $3,100 less than it originally was. As a result, Illinois taxpayers paid $900 million more in income taxes in 2004 than they would have if the exemptions had been adjusted to preserve their 1969 value.

Tax Rates

Most states use **graduated rate** schedules where the **marginal tax rates** are higher as taxable income increases. In a graduated tax rate system, different marginal rates are assigned to different taxable income brackets. The table at right shows an example in which the first $25,000 of taxable income is taxed at 2 percent, income from $25,000 to $40,000 is taxed at 4 percent, income from $40,000 to $100,000 is taxed at 6 percent and income over $100,000 is taxed at 8 percent.

A Graduated Rate Schedule

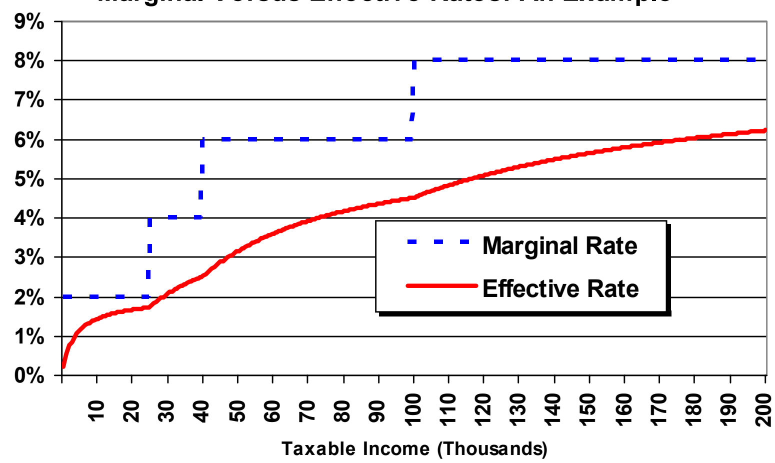
Taxable Income Bracket	Marginal Rate
0 - $25,000	2%
$25,000 - $40,000	4%
$40,000 - $100,000	6%
Over $100,000	8%

What confuses some people is that they look at a tax table like this, know that they earn $45,000 per year, for example, and conclude that they must have to pay 6 percent of their income in tax. But that isn't the way it works at all.

First, the tax rate table is based on taxable income, not total income. Thus, someone making $45,000 per year probably has *taxable* income under $40,000 after deductions and exemptions are subtracted—and taxable income is what determines your tax rate. So this person is probably only paying tax at the 2 percent rate.

Second, because these tax rates are *marginal* tax rates, even if a family does have taxable income of $45,000, only the last $5,000 of that will be taxed at 6 percent. Marginal rates apply only to taxable income *over* the amount where the tax bracket starts. This means that the effective tax rate paid at any income level (that is, the percentage of your total income you pay in tax) will always be lower than the top marginal rate. The chart on this page shows how the effective tax rate on a married couple with no children compares to the marginal tax rate at each income level, assuming the state allows a $2,000 personal exemption and no other deductions. The first $25,000 of taxable income is taxed at 2 percent, so the effective tax rate starts at zero and gradually approaches 2 percent as taxable income approaches $25,000.[9] As the marginal rate increases, the effective rate increases too—but it always remains well below the top marginal rate.

Marginal Versus Effective Rates: An Example



Some states have **flat rate** systems that tax all taxable income at the same rate. For example, Illinois has a flat rate of 3 percent that applies to all taxable income.

Credits

After computing the amount of income tax based on the applicable tax rates, **credits** (if any) are subtracted. Credits are taken directly off the *tax* amount that would otherwise be owed, as opposed to deductions, which are subtracted from the amount of *income* that is subject to tax.

Low-income credits are commonly used at both the federal and state levels to reduce income taxes on those least able to pay. Other credits are designed to provide relief from other taxes. For example, low-income sales tax rebates and property tax circuit breakers are often administered as credits against the personal income tax.

Some credits are **refundable**. This means that if the amount of the credit exceeds the amount of tax otherwise calculated, a filer actually gets money back. The reason for making a credit refundable is to assure that deserving families get the full benefit of the credit, even if they don't owe much in income taxes. The best-known refundable credit is the federal earned-income tax credit (EITC), which allows low-income working families with children to get a direct payment from the government if the amount of the credit exceeds the income taxes they otherwise would owe. In 2004, 18 states allow earned income tax credits modeled after the federal credit.

[9] Even when taxable income is exactly $25,000, however, the effective tax rate remains less than 2 percent in this example. This is because the $2,000-per-person exemption means that this family's total income is $29,000, not $25,000. Not all of the family's income is subject to the 2 percent tax.

Local Income Taxes

In most states, local taxes are much less diverse than state taxes. But more than a dozen states, seeking to move away from the property taxes that have historically dominated local revenues, now allow local-option income taxes. States allowing these taxes usually do it in one of two ways: by granting authority to every taxing district of a particular kind in a state or by granting authority to specific named districts. One example of the broader approach is Maryland, where each county government levies a "piggyback" tax that applies to the same tax base as the state income tax.

In states that already levy state income taxes, these local taxes can be administered and collected by state tax administrators on state tax forms, requiring no new paperwork. An optional local income tax helps to achieve tax diversity, fairness and adequacy for local governments.

Revenue and Stability

Because of its direct link with growth in personal income, revenue from an income tax grows with a state's economy. In fact, the more progressive the income tax, the more it grows. Why? Because virtually all income growth over the past decade has been concentrated in the top of the income scale. Thus, a state that has high rates on the wealthy captures this growth better than a state with low rates on the well-to-do. Progressive income taxes will usually grow faster than personal income over time. This is important because the cost of providing public services often grows faster than income as well.

Of course, in a severe recession, personal income tax collections will decline. But in the long run, the personal income tax is the most reliable source of revenue to fund public services.

Deductible in Computing Federal Income Tax

A final step in the calculation of state income taxes doesn't even appear on your state tax form: part of what people pay in state and local income taxes is offset by the deduction itemizers get in computing their federal taxable income. On average, every dollar that a state collects in income tax ends up costing its residents only about 80 cents, because about 20 percent of the cost of these state taxes is offset by federal tax cuts for itemizers. And, from the point of view of high-income taxpayers, every dollar paid in state income tax costs only 65 cents.

How Fair Is Your Income Tax?

A personal income tax can be designed to be as fair as lawmakers want it to be. Almost every income tax is at least slightly progressive. A progressive personal income tax is the key to a fair overall tax system: without it, a tax system is doomed to being highly regressive. With a sufficiently progressive personal income tax, the whole tax system can be made to be at least slightly progressive even if the system includes regressive sales, excise and property taxes.

But in practice, very few states have achieved this. Only a handful of states require their wealthiest taxpayers to pay as much of their income in state and local taxes as the poorest state residents. By this measure, very few tax systems can even be described as "flat." This section looks at the common pitfalls that limit income tax progressivity at the state level.

Graduated Rate Structures

The easiest way to make an income tax adequately progressive is through graduated rates. The higher the rates are on wealthier taxpayers, the lower the rates can be on everyone else to raise the same amount of revenue. But many states fall short of this goal, for a variety of reasons:

- Six states don't apply graduated rate structures at all, but use a flat tax rate that applies to all taxable income. These states are Colorado, Illinois, Indiana, Massachusetts, Michigan and Pennsylvania. Most of these states do this because constitutional rules require it.

- Some states use nominally graduated rate structures that don't mean much in practice. For example, Maryland's top income tax rate begins at just $3,000 of taxable income. As a result, 79 percent of Maryland families pay at the top rate. In states (like Maryland) that do not index their income tax brackets for inflation, this problem grows worse every year. (See the text box on the next page for more information on indexation.)
- Other states use much wider income brackets, but apply relatively low rates. For example, Arizona's top tax rate takes effect for married couples earning over $300,000—but these taxpayers pay a marginal rate of just 5.04 percent. The relatively small difference between the bottom tax rate and the top tax rate makes the Arizona income tax less progressive.

Capital Gains Tax Breaks

High nominal tax rates on the rich are indeed the simplest way to make the wealthy pay their fair share. But high rates don't do much good if there are major tax shelters for the wealthy in the tax law. The federal income tax provides a special tax break from dividends and capital gains income. Since most dividend and capital gains income goes to the wealthiest Americans, this tax break mainly benefits the wealthy while offering only a pittance to middle- and low-income families.

Capital gains tax breaks have not been shown to encourage additional investment on the federal level—and this linkage is even more tenuous at the state level. A general state capital gains tax break is highly unlikely to benefit a state's economy, since any investment encouraged by the capital gains break could take place anywhere in the United States or the world.

In addition, a substantial part of any state capital gains tax break will never find its way to the pockets of state residents. Because state income taxes can be written off on federal tax forms by those taxpayers who itemize their federal income taxes, as much as 35 percent of any reduction in state capital gains taxes will be directly offset by an increase in federal income tax liability.

And capital gains tax cut promoters ignore the significant advantages capital gains already receive. First of all, the federal income tax applies a special lower top tax rate on capital gains than it applies to other income (15 percent versus 35 percent—so the top rate on capital gains is less than half the top rate on wages). Second, income tax is only paid on capital gains when the asset is sold. This is the equivalent of only paying tax on interest earned in a bank account when it is withdrawn. Also, no income tax is ever paid on capital gains that are inherited. Thus, a significant amount of capital gains (the amount held at the time of death) are never taxed at all.

Most states currently do not have a tax break for capital gains. The federal government, however, has the mentioned lower top rate and proposals for cutting it further frequently surface.

Pension Tax Breaks

Many states provide much more generous tax breaks for pension benefits than for other income sources. For example, New York exempts the first $20,000 of private pension benefits from tax. This type of exemption creates two glaring problems of tax equity: first, it provides a tax break to taxpayers at all income levels. The benefits of the wealthiest executive receive the same treatment as the benefits of the lowest-paid worker. Second, it provides special treatment for non-working taxpayers, with no comparable break for the earned income of otherwise identical seniors. Over-65 workers whose earnings are based on salaries rather than pensions are completely excluded from this generous tax break. Since elderly taxpayers who work tend to be poor, this tax preference for unearned income is hard to justify.

Limiting pension tax breaks to low- and middle-income retirees—or replacing the pension tax break with a more general elderly exemption that applies to both earned income and unearned income—are two approaches to tax reform that would improve the perceived fairness of state income taxes.

The Importance of Indexing Income Taxes for Inflation

Many features of the personal income tax are defined by fixed dollar amounts. For instance, income taxes usually have various rates starting at different income levels. If these fixed income levels aren't adjusted periodically, taxes can go up substantially simply because of inflation. This hidden tax hike is known as "bracket creep."

Take, for example, a state that taxes the first $20,000 of income at 2 percent and all income above $20,000 at 4 percent. A person who makes $19,500 will only pay tax at the 2 percent tax rate. But over time, if this person's salary grows at the rate of inflation, she will find herself paying at a higher rate—even though she's not any richer in real terms. Suppose the rate of inflation is five percent a year and the person gets salary raises that are exactly enough to keep up with inflation. After four years, that means a raise to $23,702. Now part of this person's income will be in the higher 4 percent bracket—even though, in terms of the cost of living, her income hasn't gone up at all.

"Hidden Tax Hikes:" An Example

	Year 1	Year 5
Actual Income	$19,500	23,702
Taxed at 2%	$19,500	$20,000
Taxed at 4%	$0	$3,702
Inflation-Adjusted Income	***$19,500***	***19,500***

The way the federal personal income tax and some states deal with this problem is by "indexing" tax brackets for inflation. In the example above, indexing would mean that the $20,000 cutoff for the 4 percent bracket would be automatically increased every year by the amount of inflation. If inflation is five percent, the cutoff would increase to $21,000 after one year. After four years (of five percent inflation), the 4 percent bracket would start at $24,310. So, when the person in our example makes $23,702 after four years, he or she would still be in the 2 percent tax bracket.

Inflation has just the same impact on other features of income taxes, including standard deductions, exemptions, and targeted low-income tax credits. Unless these progressive tax breaks are indexed, they will gradually become less valuable over time—imposing a hidden tax hike on the low- and middle-income taxpayers for whom they are most valuable.

Deduction of Federal Income Taxes from State Taxable Income

Another pitfall for state income taxes is the deduction for federal income taxes paid. Since the federal personal income tax is progressive, this deduction significantly reduces the state income taxes paid by the wealthy in the nine states that allow it. In fact, for people in the top federal bracket, the state deduction for federal income taxes effectively lowers a state's top marginal tax rate by about a third. For low- and middle-income taxpayers, on the other hand, this tax break offers little or no relief.

Tax Breaks for Middle- and Low-Income Families

There are a number of ways, other than low tax rates, to keep income taxes affordable for middle- and low-income families. Large standard deductions and exemptions provide relief to all income groups, but are more significant to middle- and low-income families than to the well off. For instance, $10,000 worth of exemptions amounts to 25 percent of income for a family earning $40,000. But the same exemption offsets only 2 percent of income for a family making $500,000.

Targeted tax credits like the Earned Income Tax Credit are an even more effective (and less costly) way of making income taxes progressive. Because the benefits of these credits can be designed to phase out above a specified income level, these credits can be targeted to the low-income families who need them most, and the cost of the credit can be kept to a minimum.

Conclusion

State governments rely on three main sources of revenue—income, sales and property taxes. Of these, only the income tax is progressive. For this reason, an effective income tax, with graduated rates and a minimum of regressive tax loopholes, is the cornerstone of a fair state tax system. As noted in Chapter One, even the most progressive income taxes are usually insufficient to offset the unfairness of sales and property taxes. But a progressive income tax makes the difference between extreme and mild tax unfairness at the state level.

CHAPTER SIX
CORPORATE INCOME TAXES

Corporate taxes are an important tool for state tax fairness. In the 46 states that levy one, the corporate income tax helps to offset the regressivity of property and sales taxes. But corporate income taxes are declining as a revenue source nationwide. This decline is troublesome for two reasons: first, it appears to be at least partially the result of tax avoidance strategies by corporations rather than the conscious design of federal and state lawmakers. Second, the decline of the corporate tax means that individuals must pay a bigger share of the tax pie. This chapter surveys the basic workings of the corporate tax and looks at potential reforms.

Why Tax Corporations?

In the end, all taxes on business are paid by individuals. It may be a company's shareholders that bear the tax, or its employees, or consumers buying its products—but ultimately, these business taxes fall on individuals. So why should corporations be taxed at all?

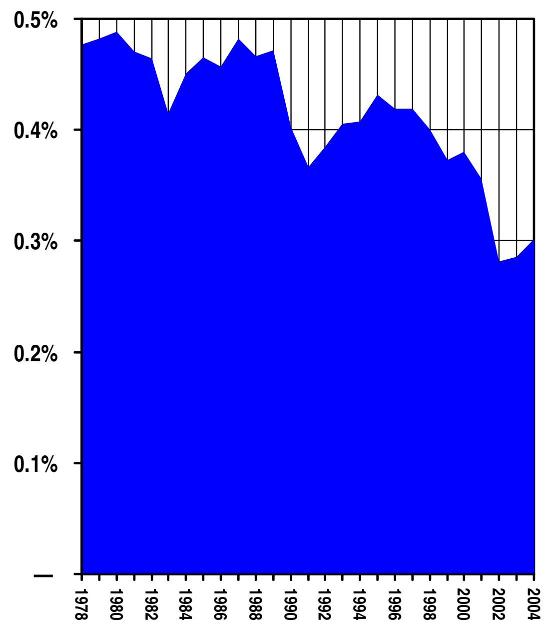
The most commonly cited reason for taxing corporations is that they derive benefits from the public services a state provides. Corporations rely on a state's education system to provide a trained workforce, use a state's transportation system to move their products from one place to another, and depend on the state's court system and police to protect their property and business transactions.

Another reason is that corporations have special privileges—limited liability and unlimited life, for example—that individuals do not have.

The corporate income tax also acts as an important backstop to the personal income tax. Without the corporate tax, much of the income of wealthier Americans would go entirely untaxed, because individuals could easily shelter their personal income by putting it in a corporate form.

In addition, states find corporate taxes attractive because they often are the only option available for taxing residents of other states. Many of the shareholders of a corporation doing business in a state likely live in other states. States seeking to tax these non-residents on the benefits their company receives from public services have no other means of doing so than the corporate tax.

State & Local Corporate Income Taxes
As a % of GDP — Fiscal 1978-2004



How it Works

Like personal income taxes, state corporate income taxes are usually based on the "ability to pay" principle. The tax applies to corporate profits—that is, income minus business expenses. Most states "piggyback" on the federal corporate income tax, using federal taxable income as a starting point in determining each corporation's state taxable income. But states must take several additional steps in determining how much (if any) of a corporation's profit they can tax.

- First, the state must determine whether a corporation has **nexus** in a state—that is, whether the company engages in a sufficient level of activity in the state to be taxable by the state.

- For those companies that have nexus with a state, the state must next divide each company's taxable income into a "business income" component and a "non-business income" component. This distinction matters because business income is typically divided up between the states depending on the location of the firm's business operations, while non-business income is typically assigned exclusively to the state in which the assets generating the income are managed—usually the state in which a company is headquartered.
- Finally, the state uses a process called **apportionment** to divide a company's business income into an "in-state" portion (which is taxable) and an "out-of-state" portion (which is not).

These additional steps are required by federal law to ensure that each state can tax only its "fair share" of the corporate profits earned by companies doing business in the United States. If these rules didn't exist, any given state would be able to tax the profits of corporations that had no activities whatsoever in the state—and every dollar of corporate income could, in theory, be taxed multiple times by multiple states. The amount of in-state activity that a business must engage in before achieving nexus with a state for corporate income tax purposes is defined by a federal law known as Public Law 86-272. This law says that states cannot apply their corporate income tax to businesses whose only connection to the state is soliciting orders in and/or shipping goods into the state.

Once states have determined the total amount of taxable business income for businesses that pass the nexus test, they divide each company's nationwide taxable business income into an "in-state" portion and an "out-of-state" portion. Each state uses its own **apportionment formula** to achieve this. In the 1950s, legal reformers worked to set up a fair, uniform way of allocating income between states that would result in multi-state businesses' profits being taxed exactly once. The result was the Uniform Division of Income for Tax Purposes Act (UDITPA). The UDITPA model legislation prescribed relying equally on three different factors in determining the share of a corporation's profits that can be taxed by a state. These factors are:

1) The percentage of a corporation's nationwide **property** that is located in a state.
2) The percentage of a corporation's nationwide **sales** made to residents of a state.
3) The percentage of a corporation's nationwide **payroll** paid to residents of a state.

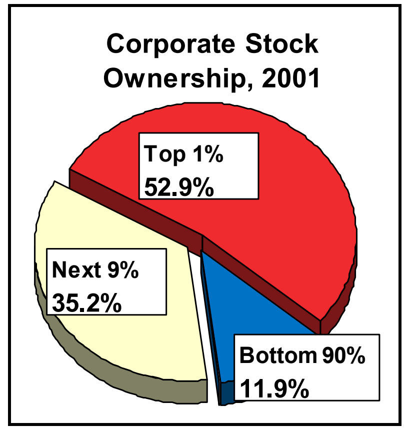
The main rationale for using these three factors to determine taxable income was that companies benefit from a state's public services in a variety of ways, including owning property in a state, making sales within a state, and having an in-state employee base. The three-factor formula ensures that corporate tax liability reflects the benefits received by each type of corporation.

The UDITPA three-factor approach prescribes assigning each of these three factors an equal weight in determining a corporation's taxable income. In other words, the percentage of a corporation's taxable income that can be considered "in-state" is calculated as a simple average of these three percentages. So, for example, suppose that the Acme Corporation has located 90 percent of its property, 30 percent of its total sales, and 90 percent of its payroll in one state. Under the three-factor formula, that state could tax 70 percent (the average of 90, 30, and 90) of Acme's apportionable business income.

For each company, the total amount of taxable income in a state is determined by adding together the amount of business income that can be apportioned to the state, plus the amount of non-business income that is attributable to the state. (As noted above, non-business income is generally allocated entirely to the state in which the assets generating that income are managed.) Taxable income is multiplied by a set of tax rates to yield a pre-credit tax amount. Most states provide special tax credits for research or investment activities which are then subtracted to yield net tax liability.

Fairness

Corporate income taxes are paid by businesses. But as with any business tax, the corporate tax is ultimately paid by individuals. Corporate income taxes are usually passed through to shareholders. Since stock ownership is concentrated among the very wealthiest taxpayers, the corporate income tax is one of the most progressive taxes a state can levy. As the chart at right shows, the wealthiest one percent of Americans held 52.9 percent of all corporate stock in 2001, while the poorest ninety percent of Americans owned just 11.9 percent of the total. Also, because most multi-state corporations have shareholders around the nation, the burden of any state's corporate tax is largely distributed to the other states in which shareholders live. The ability to export part of the corporate income tax is important because out-of-state shareholders benefit indirectly from the public services provided to in-state corporations.



Corporate Minimum Taxes

All states with corporate income taxes use corporate profits to define the tax base. This ensures that the corporate tax reflects a business' ability to pay the tax: if a corporation loses money in any year, they don't pay the tax. But the growing use of tax avoidance strategies means that many profitable corporations are now able to report artificially low (or negative) profits for tax purposes even when they've done quite well financially. These tax avoidance strategies have created the specter of profitable "zero-tax corporations." Federal tax reform legislation in 1986 created an "alternative minimum tax" (AMT) to ensure that all profitable corporations would pay some tax no matter how many loopholes they might otherwise claim.

States seeking to follow the federal government's lead have taken one of three strategies: imposing an AMT based on the federal tax, imposing a flat-dollar minimum tax, or using a non-profit-based measure of business activity as a backstop to the corporate profits tax.

More than a dozen states now use an AMT based on the federal tax. Like the regular corporate income tax, the AMT usually is defined as a percentage of corporate profits—but the AMT typically applies a lower tax rate to a much broader definition of corporate taxable income. This approach has become much less useful because the federal AMT has been seriously watered-down over time by Congress—but a state AMT based on the older federal AMT rules could still help prevent the excessive use of tax loopholes.

A growing number of states rely on a simpler, lower form of minimum tax: a flat-dollar amount that all corporations must pay. This amount ranges widely, from $50 in Ohio to a maximum of $1,500 in New York. As more and more corporations rely on tax avoidance strategies, the fixed-dollar minimum tax has become more important in these states: in New York, for example, more than sixty percent of all corporations now pay only the minimum tax. In New Jersey, 30 of the state's 50 largest corporations paid only the $200 minimum tax in 2002.

About half of the states now levy a "corporate franchise tax." In general, these taxes are based on a company's net worth. Some states also use corporate taxes based on gross receipts. These taxes are described in Chapter Eight.

Each of these options can help eliminate the "zero-tax corporation" problem—and (in some cases) can also help states to get around the problem of corporate nexus described above. Some nexus rules only apply to taxes that are based on profit. So a company that does business in a state, but doesn't have enough physical presence in the state to satisfy the nexus rule, cannot be reached by a profits-based taxed, but can be reached by a fixed-dollar minimum tax.

How "Decoupling" State Corporate Taxes From Federal Rules Can Help Shore Up Your State's Tax Base

Many of the tax breaks that reduce state tax collections are inherited from federal tax law. Since state corporate income taxes are based on federal rules, federal corporate tax breaks will usually be automatically passed on to the state level. States do, however, occasionally "decouple" from specific federal tax giveaways: a substantial majority of states decoupled from the Bush Administration's "bonus depreciation" giveaways in 2001-2003. Decoupling allows states to avoid revenue losses from certain federal tax breaks while keeping their corporate tax rules simple by continuing to link to federal tax definitions in most other areas.

Now states face a new federal tax break enacted in 2004 for manufacturers—the so-called "qualified production activities income" deduction. This new deduction was enacted to compensate manufacturers for the loss of an unjustified and illegal (under World Trade Organization law) export subsidy. Decoupling from this new tax break makes sense because this manufacturers' tax break is in no way tied to the creation of manufacturing jobs in any particular state. Massachusetts has already decoupled from this new federal tax break, and the other states with corporate income taxes can do so as well.

Deductible in Computing Federal Income Tax

Like the personal income tax, corporate income taxes are deductible for federal corporate income taxpayers. Since the federal corporate income tax rate is 35 percent, this means that up to 35 percent of the state corporate income tax paid by businesses in your state will be ultimately paid for not by these businesses but by the federal government, in the form of reduced federal tax collections. This interaction also means that state corporate income tax increases are subsidized by the federal government—and that part of any state corporate income tax cut will never be received by in-state businesses, but will go instead to federal tax coffers.

Revenue and Stability

Corporate income taxes can raise significant revenues—but they are also quite volatile. Corporate tax collections have declined in recent years, in part due to the slow economy. The corporate income tax is affected by the state of the economy because the tax is based on corporate profits, which usually fall significantly during economic downturns. State corporate income taxes are also facing downward pressure because they are linked to the federal tax code: the proliferation of tax loopholes at the federal level is being passed through, in many cases, to state governments. Another reason for declining corporate income tax revenues is that many companies have become better at taking advantage of loopholes that Congress never intended to create.

Corporate Income Tax Issues

The decline of the state corporate income tax has been so dramatic in recent years that a few anti-tax advocates have suggested repealing the tax entirely, arguing that the limited yield of the corporate tax makes it not worth the trouble of collecting. But this pessimistic outlook ignores a set of easily administrable, sound reforms that could help revitalize the state corporate tax. This section looks at problems facing the state corporate income tax, and suggests possible reforms.

Tax Credits and the Incentive Illusion

Many states give businesses numerous **tax credits** that significantly reduce (or even eliminate) their tax liability. These include credits supposedly intended to create jobs or encourage investment. Unfortunately, these credits usually just reward businesses for doing things they would have done anyway—or shift investment into areas that do not make the most economic sense.

The **investment tax credit** (ITC) is one example. Under the ITC, when a firm makes a qualifying investment, a percentage of the investment is allowed as a dollar for dollar reduction in the firm's tax liability. The theory is that companies will invest more if they are rewarded with tax breaks.

In practice, however, if an investment makes business sense, the company will generally make it whether there's a tax credit or not. Thus, the ITC largely rewards companies for what they would have done anyway and therefore does not serve as an economic growth stimulus at all.

Ironically, to the limited extent that businesses do make investments because of the tax credit, it's bad for the national economy. The country is better served by investments based on sound business grounds than those based on the tax code.

The ITC is also very expensive, and the majority of its benefits typically go to only a few very large firms. In fact, three-fourths of the federal investment tax credits from 1981 to 1986 went to firms with over $250 million in assets—the top one-tenth of one percent of companies. Similarly, in New York in 1985, five companies, each with over one billion dollars in net profits, got 44 percent of the state's total investment tax credits—more than $100 million worth. As a result, at least one of these billion-dollar companies paid only the $250 minimum New York corporate tax.

The question for policymakers is whether they want to support a program that:

- gives a large amount of scarce government funds to huge corporations;
- doesn't cause companies to significantly change their overall investment levels; and
- to the extent companies do change their investment patterns, is usually bad for the nation's economy.

The federal government abandoned its own investment tax credit in 1986 after Congress and President Reagan concluded that it was ineffective in stimulating investment.

Manipulating Apportionment Rules in the Name of Economic Development?

In determining what portion of a multistate company's profit is taxable in a given state, most states use the three-factor, payroll-property-sales apportionment formula method described on page 37. In recent years, however, many states have deviated from this basic three-factor approach by increasing the importance of the "sales factor." For example, Arizona allows companies to count the sales factor twice. (In the example on page 37, this means that instead of taxing 70 percent of a company's business income (the average of 90, 30 and 90), Arizona can only tax 60 percent of that income (the average of 90, 30, 30 and 90). This "double weighting" approach reduces the tax paid by corporations that sell most of their products in other states—for example, manufacturing corporations. A dozen states still use the unweighted UDITPA formula.

Several states have gone even further, increasing the weight of the sales factor to one hundred percent—eliminating the payroll and property factors entirely. This is known as the "single sales factor," or SSF. Under SSF, the sole determinant of a corporation's state tax is how much of its sales are made to in-state customers. Advocates of increasing the sales factor claim that it encourages exporting businesses to locate in a state, since it favors companies with greater payroll and assets in a state than sales. But claims that an increased sales factor attracts corporate investment are dubious. Indeed, in some cases, it might actually *discourage* investment in a state.

If a company, for instance, only ships products into a state, it may not have nexus with the state. But in a state with an increased sales factor, if such a company makes even a small investment in a state, it will immediately have much of its income apportioned to the state because the sales factor counts so heavily. And a company with only a small amount of property or payroll in a sales factor state can reduce its in-state corporate taxes to zero by moving this property and payroll out of the state. Thus, increasing the sales factor can actually have exactly the opposite effect of what its proponents intend: discouraging in-state investment.

In addition, increasing the sales factor discriminates between companies in a way that is hard to defend. Increasing the sales factor will reduce taxes for some companies, but will increase taxes for others. For each corporation that benefits from SSF because most of its sales take place in other states, there are also corporations that will be punished by SSF rules because their sales are

mostly *in*-state. Smaller corporations that tend to make most or all of their sales within the state in which they are located generally get little if any tax savings under the SSF approach. In short, adoption of the single sales factor ultimately benefits some corporations while punishing others in an arbitrary way.

These arbitrary distinctions reduce the confidence of the public—and of corporations—in the fairness of state tax administration. When profitable companies benefit from a state's services—as the manufacturing companies that typically benefit from the single sales factor clearly do—they should pay their fair share of the corporate tax burden. When these corporations are allowed to reduce or eliminate their tax liability, that lost revenue must be made up by other competing companies—and by individual taxpayers.

Separate Accounting & Transfer Pricing

A further inconsistency in state corporate taxes stems from the fact that some states permit companies to determine their in-state taxable income using **separate accounting** for each of their related subsidiaries. Separate accounting is a bookkeeping procedure that determines each company's taxable income by having companies keep separate accounts for their in-state and out-of-state business segments. Every transaction between the legally distinct subsidiaries of a company is supposed to have a **transfer price** (that is, the "sales price" at which these companies are essentially selling products to themselves) attached to it, which is supposed to be carefully scrutinized by auditors.

Not surprisingly, separate accounting is subject to abuse by large, multistate companies. In fact, it's an open highway for corporate tax avoidance. A large multistate company can use separate accounting to shift taxable profits to low-tax jurisdictions. Here's how it works:

Consider a multistate company that has two subsidiaries, one in State A that permits separate accounting and one in State B, which has no corporate income tax. To reduce its taxable profits, the subsidiary in State A might say that it "pays" high transfer prices for the items it "buys" from the State B subsidiary. This shifts income out of State A (where it would be taxed) and into State B (where it's not).

For example, a furniture company might machine the metal parts for its furniture (handles, knobs, etc.) in State B, but assemble the furniture in State A. The company will, on paper, charge very high prices to its State A subsidiary for the metal parts. This makes the State B subsidiary look like it has very high profits (which are not taxed) and the State A subsidiary look like it has very low (taxable) profits.

Of course, except for tax considerations it doesn't matter to the parent company if its State B subsidiary has 80 percent of the total profits and its State A subsidiary has only 20 percent. Either way, the parent company gets 100 percent of the profits.

Another example of transfer pricing that has gotten more attention in recent years is the passive investment company (PIC) approach. In this variation on the transfer pricing scheme, a multi-state company will set up a subsidiary in a state that does not tax certain types of intangible income like royalties and interest—and make sure that this subsidiary receives all of the company's royalty income. The most infamous example of this practice is the Toys R Us corporation, which created a subsidiary in Delaware called Geoffrey, Inc. The subsidiary owns the Toys R Us trademark, and Toys R Us stores around the nation pay royalty fees to the Delaware subsidiary for their use of the trademark. This reduces the taxable profit of Toys R Us in two ways: stores based in other states get to deduct their royalty payments as a cost of doing business, which reduces their taxable profit, and the Delaware subsidiary pays no tax on their royalty income because Delaware does not tax such income.

Trying to assure accurate transfer pricing under separate accounting creates huge enforcement problems. It is a time-consuming, complicated and often impossible job for state auditors to

determine whether separate accounting methods accurately reflect a company's net business income in the state. The federal government, which tries to apply the same approach to multinational corporations, has had the same kinds of difficulties.

States seeking to prevent these income-shifting strategies have two options. They can close down these loopholes one at a time—as some states have done in response to the PIC problem by enacting legislation that prevents the use of PICs—or they can adopt a comprehensive solution known as **combined reporting**. Combined reporting requires a multi-state corporation to determine its apportionable income by adding together the profits of all its subsidiaries into one total. Since the income of subsidiaries in the various states is added together in one sum, there is no tax advantage to income shifting between these subsidiaries under a combined reporting regime. While anti-PIC legislation can close down one particular path to tax avoidance, combined reporting is a better, more comprehensive approach to loophole-closing because it simply removes the incentive to shift income from high-tax to low-tax jurisdictions.

Combined reporting is intuitively more fair than separate accounting because it ensures that a company's tax should not change just because its organizational structure changes. It also creates a level playing field between smaller and larger companies. Small companies doing business in only one state can't use separate accounting to reduce their tax because they have no business units in other states to shift their income to. Large, multi-state corporations will find it easier to avoid tax using separate accounting because they have business units in multiple states.

"Nowhere Income" and the Throwback/Throwout Rule

Every state with a corporate income tax uses the location of the corporation's sales as a factor in apportioning business income between states. The "sales factor" for a given corporation in a given state is calculated by assigning each individual sale a company makes to exactly one state, and then calculating what percentage of total nationwide sales are in each state. In general, the rule states use to decide which states a given sale should be assigned to is the "destination rule," which says that a sale should be assigned to the state to which the product sold is being sent.

Sometimes, however, sales allocated to other states using the destination rule end up not being taxed at all because the destination state lacks the authority to tax the seller. When this happens, it's because the seller doesn't have *nexus* in the destination state.

Unless states take action, this "**nowhere income**" will not be taxed anywhere at the state level. The best remedy for the problem of nowhere income is enacting a **throwback rule**, which simply says that any sales to other states that are not taxable will be thrown back into the state of origin for tax purposes. The throwback rule was among the tax rules adopted by the UDITPA in the 1950s, but many states still have not enacted it. The lack of throwback rules poses a major threat to state corporate income tax revenues in twenty states.

Splitting Hairs? Exploiting the Business/Nonbusiness Income Distinction

The first step in calculating state corporate taxes is dividing a company's income into a "business income" component and a "nonbusiness income" component. Business income is apportioned (divided) between the states in which a company does business, while non-business income generally is taxed entirely by the one state in which the asset generating that income is managed. But each state must set its own legal dividing line between business- and non-business income—and the way in which states do this has important implications for corporate tax fairness.

The appropriate dividing line between these two types of income has been the topic of frequent litigation in the states. In many states, business income is defined as any income that arises from the regular transactions that a company typically engages in—which means that any income that can be characterized as "irregular" may be considered non-business (and therefore non-apportionable) income. Businesses sometimes try to take advantage of this poorly defined distinc-

tion between business and non-business income by misleadingly classifying some business income as irregular non-business income, then allocating this non-business income entirely to a low-tax state in which they are nominally headquartered. A 1992 U.S. Supreme Court case, *Allied Signal v. New Jersey*, made it clear that many states currently falling prey to these tax-minimization strategies are not taxing all the corporate income they could legally tax.

States with corporate income taxes have responded to these corporate tax-minimization efforts using two strategies:

- Six states define business income as everything they can legally apportion under the U.S. Constitution—which means that non-business income is whatever is left over. This approach is recommended by corporate tax experts as the best way of fairly taxing multistate corporations' income.[10]
- Thirteen states define all income as business income. This approach allows states to tax some of the "irregular" income that companies seek to classify as non-business income, but prevents states from taxing some non-business income that they are entitled to tax. For example, if a company is based in state A, and generates $100 million of non-business income in state A, the state should be entitled to tax the entire amount as non-business income (since non-business income is not apportioned between states). But when states make no distinction between business and non-business income, all of a company's income is apportioned—which means that state A can only tax a percentage of this income.

Every state with a corporate income tax (except for the six states that currently define business income in accordance with the U.S. Constitution's limits), could enact statutory changes that would allow them to prevent the nonbusiness income loophole from depleting their tax base.

Corporate Disclosure: An Important Tool for Tax Fairness

Tax fairness is important. The perception that state and local taxes treat individuals and corporations fairly is a cornerstone of public support for the tax system. Corporate tax fairness at the federal level can be evaluated, with some difficulty. Publicly available Securities and Exchange Commission (SEC) filings allow analysts to determine how much the nation's largest corporations have paid in federal taxes and compare this to their profits. In a series of reports, ITEP has shown that many profitable corporations pay little or no federal income tax. A September 2004 ITEP report surveyed 275 of the most profitable corporations, and found that almost a third of these companies paid zero (or less) in federal taxes in at least one year between 2001 and 2003.

Unfortunately, the fairness of state corporate taxes cannot be evaluated in the same way, because neither the SEC nor most state governments require corporations to release detailed information on their state corporate tax payments. A few states have now implemented some form of corporate tax disclosure. For example, Massachusetts now requires very limited anonymous disclosure of basic information about profits, taxes paid and tax credits received. But nearly all states still have no such requirements. Greater state corporate tax disclosure is the best means available to ensure that each corporation is treated fairly—and that corporations as a group pay their fair share of taxes.

Corporate disclosure can also help states to prevent the accounting hijinks described above. For example, some companies will report certain income as "non-business income" in one state and "business income" in another to minimize their tax liability. More open reporting of this information could allow states to check for consistency in income reporting between states.

[10]Michael Mazerov, *Closing Three Common Corporate Tax Loopholes Could Raise Additional Revenue for Many States* (Center on Budget and Policy Priorities, 2003).

CHAPTER SEVEN
OTHER REVENUE SOURCES

State tax systems are constantly in flux, as new revenue sources develop and old ones wither away. This chapter looks at two revenue sources that have traditionally formed a small part of the state tax pie: the estate tax and gambling revenues.

Estate and Inheritance Taxes

Since the federal government enacted an estate tax in 1916 to "break up the swollen fortunes of the rich," every state has enacted a similar tax of its own. While these taxes typically represent only a small part of overall state tax collections, estate taxes play an important role in reducing the transmission of concentrated wealth from one generation to the next. This function is now more important than ever: in 2001, the wealthiest 1 percent of Americans owned 32.7 percent of the wealth nationwide—more than the poorest 90 percent put together. [11] The estate tax was designed to apply only to the very wealthiest Americans—and that's exactly what it does. Nationwide, less than two percent of decedents typically owe any federal estate tax.

Recent federal tax changes, however, threaten the future of the estate tax at the state level. Since 1926, the federal estate tax has allowed a dollar-for-dollar tax credit against the estate taxes levied by states, up to a certain maximum amount. The credit gave states an incentive to levy an estate tax at least as large as this credit: in the states levying a "pickup tax"—that is, a tax calculated to be exactly equal to the maximum federal tax credit—the state's estate tax amounted only to a transfer of estate tax revenues from the federal government to the states. In other words, the pickup tax did not change the amount of estate tax paid—it just meant that part of the federal estate tax liability was being shared with, or "picked up" by, state governments. Every state took advantage of this incentive to enact the pickup tax.

Federal tax cuts enacted in 2001 are scheduled to repeal the federal estate tax over ten years —and, more importantly for the states, to phase out the federal credit allowed for state estate taxes between 2002 and 2005. The federal credit declined by 25 percent in 2002, 50 percent in 2003, 75 percent in 2004, and ceases to exist in 2005. In many of the states that base their tax on the federal credit, this means that the state's estate tax will also cease to exist in 2005 unless states take action to prevent this from happening.

States seeking to preserve this important progressive revenue source have an easy way of doing so: "decoupling" from the federal tax repeal. The easiest way to achieve this is by defining the state estate tax to equal the federal credit as it existed in 2001—before the passage of the Bush administration's estate tax cuts. A number of states have made this simple administrative change already.

Gambling Revenues

Like tax policy, gambling policy is made in a decentralized way: each state's lawmakers can choose which forms of legalized gambling to allow. As a result, the states now have very different approaches to allowing gambling activities. Some form of government-sanctioned gambling is now allowed in all but two states (Utah and Hawaii). By far the most popular forms of legalized gambling are lotteries and casinos: 37 states and the District of Columbia have state lotteries, and more than half of the states have some form of casino gambling. Many states also allow "pari-mutuel" gaming, wagering on live events such as horse racing and greyhound racing.

[11] Arthur Kennickell, "A Rolling Tide: Changes in the Distribution of Wealth in the US, 1989-2001", November 2003. Levy Economics Institute Working Paper No. 393.

Advocates of state-sponsored gambling typically see it as a painless, voluntary tax—and one that is at least partially paid by residents of other states. At a time when lawmakers' willingness to increase politically unpopular taxes is especially low, a tax paid by non-residents may seem especially palatable. It is also argued that in the absence of legal gambling, many state residents will either gamble illegally or travel to other gambling-friendly states—with no benefit to the state. But opponents raise a host of troubling objections to states' use of legalized gambling.

- Even if gambling boosts state revenues in the short run, **competition from other states** will eventually make state-sponsored gambling less profitable—and will ultimately put the burden of this tax primarily on state residents rather than tourists from other states. Increased competition also means that the **yield of the tax will likely decline over time**.
- Instead of increasing the total amount of revenue available to fund public services, **gambling may simply shift money from one tax to another** with no net gain to the state. When consumers spend more money on gambling, they will spend less money on other items. Since these other types of purchases are usually subject to state sales taxes, any increase in state gambling revenue usually means a decrease in state sales tax revenue.
- Rather than simply capitalizing on existing illegal gambling activities, legalized gambling may **encourage consumers to gamble more** than they otherwise would. When states use gambling as a revenue source, they depend on the continued flow of this revenue to fund services. This often leads to state-sponsored advertising that actively encourages citizens to gamble more. In this respect, gambling is very different from "sin taxes" on alcohol and cigarettes, which are often enacted not to raise money but to discourage behavior that is deemed socially harmful.
- **Promises of additional spending for specific public services may be illusory**. Advocates of state-sponsored gambling often seek to earmark gambling revenues for specific purposes, usually to help fund education. These advocates often promise that total state spending on education will increase as a result of the new gambling revenues. But it is just as likely that lawmakers will use gambling revenues to replace other revenues that have been shifted from education to other areas—leaving the total amount of spending on education unchanged.
- Low-income and poorly-educated taxpayers are far more likely to participate in lotteries and other forms of gambling than are wealthier, better-educated taxpayers. As a result, state-sponsored gambling can be considered **a regressive tax**.
- Like other "sin taxes," gambling is **not always a truly voluntary tax**. Compulsive gambling has been recognized as an addictive disease. Relying on compulsive gamblers to fund public services amounts to taking advantage of these gamblers' addictions. And because state gambling administrators tend to downplay the poor odds of winning, gamblers are usually given incomplete information about these odds—which means, in a sense, that gamblers are being tricked into these "voluntary" spending decisions.
- Gambling may introduce a variety of **social costs**, including increased crime rates, decreased private savings, increased debt, and job losses. These social costs can result in increased social welfare spending by state governments in the long run.

The slow economic growth of the past several years has forced policymakers across the nation to make painful fiscal policy decisions. It is understandable that lawmakers have sought every opportunity to avoid general tax increases while continuing to provide public services. But policymakers in many states have moved away from the estate tax, which affects only a small number of the wealthiest Americans, and have increased their reliance on regressive gambling revenues, which are far more burdensome to low- and middle-income taxpayers. And the unpredictable yield of gambling revenues means that lawmakers using lotteries as a "quick fix" to avoid politically difficult structural tax reforms in the short run will likely be forced to confront the same difficult tax policy decisions in the future.

CHAPTER EIGHT
THINKING OUTSIDE THE BOX: OTHER TAXES

Most of this report's chapters have focused on ways of reforming the major taxes currently levied by state and local governments. But some states use unusual revenue sources that other states don't—and these taxes are occasionally proposed as options for comprehensive tax reform. This chapter looks at two such proposals: the value-added tax and the gross receipts tax.

Value-Added Taxes (VATs)

In recent years, lawmakers in a number of states have suggested that a particular type of sales tax, called the value-added tax or VAT, might be a cure-all for state budgetary problems. Although Michigan is the only state that currently relies on a VAT as a major revenue source, several other states have recently considered implementing this type of tax.

The value-added tax is exactly what its name implies. It is a tax on the *value added* at each stage of the production of goods and services. For any firm paying the VAT, the "value added" for a particular item is the amount by which the sales price of the product exceeds the cost of all the products purchased to make that item. Because the tax is paid at each level of production, and is often not itemized on the final bill to consumers, some try to characterize the VAT as a tax on business. But most analysts agree that "the value-added tax is essentially a sales tax on consumer purchases that businesses collect in stages."[12] From a tax fairness perspective, in other words, a VAT is just like a sales tax—it's regressive, requiring low-income consumers to pay more of their income in tax than wealthier taxpayers must pay.

How a Value-Added Tax Works

	Price	Value Added	Tax at 5%
Raw materials	$40	$40	$2
Manufactured product	140	$100	5
Wholesale sale	200	$60	3
Retail sale	300	$100	5
Total		**$300**	**$ 15**

The following example shows how a VAT would apply to the production and sale of a chair:

- First, a supplier sells raw materials (for example, wood) to a manufacturer for use in producing the chair. If the raw materials are sold for $40, the materials supplier pays tax on the whole $40. A five percent tax rate on the $40 of value added equals a $2 tax.
- Second, the manufacturer builds the chair and sells it to a wholesaler for $140. The manufacturer pays a VAT only on the value it has added to the chair. Since the manufacturer has taken raw materials worth $40 and made a chair worth $140, the manufacturer's value added is $100. A five percent tax on the $100 value added is $5.
- Third, the wholesaler sells the chair to a retailer for $200. The wholesaler bought the chair for $140 and sells it for $200, so the wholesaler's value added is $60. The five percent tax is $3.
- And finally, the retailer sells the chair for $300. Since the retailer bought the chair for $200 and sold it for $300, the retailer's value added is $100—and the five percent tax is $5.

At the end of this process, the outcome from the consumer's perspective is just the same as if the state had imposed a retail sales tax on the $300 price. The main difference is that the VAT is collected a little bit at a time at each stage of the production process, rather than being collected in one lump sum at the time of the final retail sale.

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[12]Congressional Budget Office, *The Economic Effects of Comprehensive Tax Reform*, 1997

Why Adopt a VAT?

Policymakers seeking to impose a state VAT usually have one of two tax policy goals in mind, depending on which existing tax they want to replace. European VATs were created to eliminate structural problems in existing sales taxes. In particular, European sales taxes often applied not only to retail purchases but to "business to business" transactions which should be exempt. When sales taxes apply to these business inputs, the tax is typically passed through to consumers in the form of higher retail prices. In other words, taxing business inputs amounts to taxing consumers multiple times on the same retail purchase. This problem, known as "pyramiding," is discussed in more detail in Chapter Three. Pyramiding is both regressive and unpredictable (because the number of times the tax is paid depends on the number of stages of production), and encourages businesses to "vertically integrate" to avoid paying taxes on inputs to the production process. VATs are especially well designed to avoid taxing business inputs, since each component of a retail product's value added is taxed exactly once. In other words, European countries replaced their poorly structured sales taxes with a better-functioning sales tax.

In Michigan, the rationale for adopting a VAT was quite different: their VAT was adopted to replace the corporate income tax, not the sales tax. Corporate income taxes tend to fluctuate widely over the business cycle because they are based on corporate profits, which vary dramatically during periods of economic growth and downturns. Michigan's corporate tax was especially volatile due to the importance of auto sales to its economy. A VAT is an inherently more stable and predictable revenue source than a corporate profits tax, because the tax base is a firm's total amount of economic activity rather than its profits. In other words, Michigan replaced its corporate profits tax with what amounts to a second sales tax, choosing revenue stability as a primary goal of its "Single Business Tax."

Problems with a VAT

Each of these rationales has some merit: replacing a sales tax with a VAT will improve the horizontal equity of the sales tax (by ensuring that each retail transaction is taxed the same way), and replacing a corporate profits tax with a VAT will make revenues more stable. But implementation of either approach at the state level is problematic, for several reasons:

- What works on a national level in Europe may not work on the state level in America. If one state adopts a VAT while neighboring states do not, the inability of states to tax purchases from some out-of-state sellers will mean that some value added won't be taxed, and sales made to other states will create the same problem. Put another way, a VAT can't easily work in one state without a lot of help from other states.
- Unlike a retail sales tax, a VAT often isn't itemized on retail receipts (although it can be). Thus, consumers may be less aware that they are paying a VAT. Invisible taxes make it harder for consumers to see how much they are really paying.
- People don't understand how VATs work. Calling a VAT a "Single Business Tax" may fool people into thinking that a VAT falls on business rather than consumers.
- Abandoning a corporate profits tax for a VAT makes the tax system less responsive to a business' ability to pay taxes. This is part of the reason why Michigan's VAT is currently slated to be repealed by 2009: the VAT is especially painful for businesses not turning a profit.
- Because a VAT is passed through to consumers like a sales tax, replacing a corporate profits tax with a VAT will make already-unfair state tax systems even more regressive.

Value added taxes have been enacted internationally to address important concerns about structural flaws in sales taxes. But as a replacement for corporate profits taxes on the state level, the main impact of a VAT will be a more regressive tax system—and a host of angry businesses.

Gross Receipts Taxes

A **gross receipts tax** (GRT) is still another type of sales tax. The main difference between a retail sales tax and a GRT is that sales taxes apply (in theory, anyway) only to retail sales, while a GRT applies to the sales made by companies at every stage of the production process, including manufacturing companies, wholesalers, and retailers. In other words, a GRT is a sales tax that applies to more types of transactions. From the consumer's perspective, the major distinction between gross receipts taxes and retail sales taxes is that gross receipts taxes are not necessarily itemized on customers' bills.

The gross receipts taxes currently used by states typically only apply to the sales receipts from certain types of products, with utilities and insurance being the most common targets. In fiscal year 2002, state and local governments raised more than $30 billion in gross receipts taxes on utilities and insurance—twice as much as what the states raised from excise taxes on alcohol and tobacco.

When state policymakers propose a gross receipts tax as a proposal for comprehensive tax reform, however, what they usually have in mind is something very different from the single-item gross receipts taxes that most states currently use. These proposals typically would impose a very low tax rate on a very broad base of economic activity. For example, a Nevada tax reform commission recently proposed a gross receipts tax of 0.25 percent on all business revenues over $450,000 a year.

This sort of gross receipts tax is quite rare on the state level. The most comprehensive current GRT is the Washington State Business and Occupation Tax, which taxes different types of companies at different rates ranging from 0.138 percent to 1.5 percent.

There are three main problems with GRTs. First, like any sales tax, a GRT hits low-income taxpayers the hardest. Second, because GRTs are based on the amount that a business sells rather than on its profit, a GRT is not sensitive to a business' ability to pay. Third, GRTs lead to severe pyramiding problems, because the tax applies not just to retail sales but to all stages of the production process.

The first two of these problems are basically identical to those faced by value added taxes (see above); the third, however, separates GRTs from VATs. VATs are explicitly designed to get around the problem of tax pyramiding, while GRTs have no mechanism for avoiding it. As a result, it doesn't make much sense to compare the tax rate of a broad-based GRT to the tax rate of a general sales tax: a GRT is a multi-stage tax, whereas the sales tax is a single-stage tax. So, for example, if a GRT of 0.25 percent applies to four stages in the production of a product, that's roughly equivalent to a retail sales tax of one percent.

As in Michigan, some of the strongest opposition to Washington's GRT comes from businesses. The firms that tend to dislike the Washington state tax most are those that engage in high-volume, low-profit-margin activities—and those that frequently don't turn a profit at all.

CHAPTER NINE

TAXES AND ECONOMIC DEVELOPMENT

One of the main concerns of state policymakers is how to lure jobs to their state—and too often, policymakers assume that tax cuts make the best bait. It's not hard to understand why they might believe this: tax-cut advocates frequently assert that cutting tax rates will spur economic growth by bringing more jobs and employers to the state, and footloose businesses are constantly threatening to relocate to other lower-tax jurisdictions if state governments won't pony up lavish tax breaks. But there is growing evidence that tax cuts and incentives are not an effective growth strategy for states—and that investing in public infrastructure such as schools, roads and hospitals can be a better approach to encouraging economic development. This chapter discusses the relationship between state fiscal policies and a state's economic climate.

How Taxes Affect State Economies

When state policymakers discuss proposed tax increases, the debate inevitably turns to the impact of these proposals on the state's business climate. Business lobbyists usually argue that tax increases will hurt a state's business climate and drive away industries and jobs. And if tax increases aren't on a state's agenda, the same lobbyists will push for special tax breaks to encourage new business investment—or to prevent a company from leaving the state—and will tell apocalyptic tales about what will happen if these business demands are not met.

But there is very little hard evidence to support the assertions of those who see tax cuts as a panacea for a state's economy. A recent comprehensive survey of the economic literature on the relationship between taxes and economic development by economist Robert Lynch found little evidence that state and local taxes are important factors in determining business location decisions or in affecting state economic growth.[13]

Lynch's survey suggests that there is wide variation in the quality of the "research" used to support these anti-tax arguments, and suggests that the studies that do show strong relationships between tax levels and economic development often have design flaws that invalidate their conclusions. But for the average advocate, who does not have an advanced degree in economics, it can be difficult to tell the difference between high-quality and low-quality research. Fortunately, these poor-quality studies tend to share the same design flaws. Here's a quick overview of some important questions to ask in evaluating these studies:

Does the study assume that tax changes have no effect on public spending? One of the most frequent errors made by these studies is to simply ignore the linkage between taxes and public spending. This is equivalent to saying that when taxes are hiked, the resulting revenues will simply be thrown away rather than being used to fund education and other public services—and that when taxes are cut, there will be no reduction in the state's ability to fund these services. Of course, the world doesn't work this way. In the real world, tax cuts must be paid for—and that usually means spending cuts. And when strapped lawmakers pass politically unpopular tax increases, the new revenue is used to preserve important state services.

Studies that ignore this basic linkage and look only at the impact of tax cuts are merely stating the obvious: state economies would be stronger if they could maintain the current package of public services while paying less for them. In the best of all possible worlds, state and local governments would provide all of our public services for free. Of course, that's unrealistic—but that's the implication of studies that don't factor in the impact of tax cuts in public services.

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[13]Lynch, Robert G., *Rethinking Growth Strategies: How State and Local Taxes Affect Economic Development*, Economic Policy Institute, March 2004.

Does the study measure the impact of any other possible explanations for economic growth? There are many plausible explanations for the difference between fast-growing and slow-growing state economies. These differences could result from tax law changes, government spending behavior, regional and national economic changes, demographic changes, or even the weather. The simplest "studies" often measure the linkage between only one explanation—tax levels—and an economic outcome. But if the study doesn't at least try to measure the impact of these other factors, its findings shouldn't be taken seriously.

Does the study measure tax burdens correctly? Anti-tax advocates frequently resort to manipulating data in arcane ways to back up their assertions. For example, some studies use the "per capita" tax burden—that is, the total amount of taxes collected in a state divided by the state's population—to identify high-tax states. The problem with this is that "per capita" tax measures tell us more about how rich a state is than how high its taxes are. For example, Connecticut collects $1,065 per capita in personal income tax, while Maine collects $829. Yet Connecticut's income tax has lower tax rates and higher exemptions than Maine's income tax. Virtually anyone moving from Maine to Connecticut would, in fact, see their income taxes go down. This approach to measuring tax burdens is simply misleading—but anti-tax advocates rely on it simply because the average reader won't know this. Other data manipulation tricks that these advocates frequently use include:

Comparing State and Local Taxes: Connecticut and Maine

	Connecticut	Maine
Income Taxes Per Capita	$ 1,065	$ 829
Rank	6	16
Personal Income Per Capita	$ 43,173	$ 28,831
Rank	2	33
Income Tax as % of Income	2.5%	3.0%
Rank	20	12

Source: Census Bureau, Bureau of Economic Analysis

- Making assertions about how total taxes affect growth—but backing these assertions up using only state tax data. State tax hikes are often enacted to reduce local taxes, so it is important to use the combined state and local tax burden in evaluating these assertions.
- Using legal tax rates as a measure of true tax burdens. This trick is frequently used in states that combine high income tax rates with generous deductions, exemptions and other tax breaks. Effective tax rates—that is, taxes as a share of income (or profits, in the case of businesses) are a far more accurate approach to measuring tax burdens.
- Using aggregate tax collections data to measure state tax burdens instead of measuring the incidence of these taxes on state residents. Aggregate measures based on total tax collections tell us little about whether specific groups of taxpayers experience the state as a high-tax or low-tax place to live. Some nominally "high-tax" states rely heavily on taxes paid by businesses or non-residents, which don't apply to state residents.
- Not factoring in the deductibility of state and local income and property taxes when comparing tax burdens across states. The ability to write off these taxes means that the difference in tax levels between "high tax" and "low tax" states is never as large as it may seem. For the wealthiest taxpayers (and for profitable corporations), up to 35 percent of the difference between any two states' tax burden will disappear once federal deductibility is taken into account.

Much of the "research" that is commonly cited by anti-tax advocates is based on research methods that are dubious at best—and the tricks outlined above tend to get recycled in different states by anti-tax lobbyists. So whenever lawmakers or the media are presented with a study purporting to show that high taxes hurt economic development, it's a good idea to ask these basic questions about the design of these studies.

Why Low-Tax Strategies Don't Work

So why is it that the doomsday scenarios of corporate lobbyists fail to materialize when taxes are increased? No doubt, all things being equal, businesses would prefer low taxes to high taxes. But in fact, all things are *not* equal. Taxes are levied for a very important purpose: to help fund the public services that make a state more attractive to businesses. Good roads and bridges, a well-educated workforce and other government services are essential to business productivity and profitability. And there is a clear linkage between raising taxes and a state's ability to provide these important public services.

And on the other side of the coin, low taxes generally lead to low-quality public services. Providing businesses with a low-tax, low-service environment is not likely to be a winning strategy for attracting significant new investment. Moreover, compared to other costs of doing business, state and local taxes are rather insignificant. That's why heads of major corporations will candidly admit that taxes are not very important in their location decisions.

As Paul O'Neill, a former executive at Alcoa put it: "I never made an investment decision based on the tax code...If you are giving money away I will take it. If you want to give me inducements for something I am going to do anyway, I will take it. But good business people do not do things because of inducements. "[14]

Other corporate leaders have echoed these thoughts. For example, long-time business leader Michael Bloomberg told the New York Times that "any company that makes a decision as to where they are going to be based on the tax rate is a company that won't be around very long. If you're down to that incremental margin you don't have a business."[15]

Likewise, John Tyson, of Tyson Foods, a $4 billion a year business, noted that tax breaks had nothing to do with his company's decision to locate a plant in Pine Bluff, Arkansas, rather than out of state. "It [the location decision] was based purely on geography. Pine Bluff was in the right place. The tax credits didn't make any difference."[16]

The Corporation for Enterprise Development (CFED) has issued a series of reports grading states on the characteristics that are likely to attract high-wage, high-value-added industry. Level of taxation has consistently been found to be of little significance. The factors that really drive location decisions include the quality of life in the community, a good supply of highly skilled and educated men and women to fill demanding technical and management positions, good roads and adequate transportation, public safety, and the quality of health care.

When corporations raise the "business climate" issue, it's usually nothing but a ruse to try to keep their taxes low. For example, a corporation might negotiate with two states over where to locate a facility in hopes of starting a bidding war, with each state offering more tax breaks than the other. Finally, after the corporation has been promised the tax breaks it wants (or more) from each of the states, it will locate in one state or the other. The location decision, however, very likely will have actually been made long before the bidding started. The company just plays the states off each other, promising jobs and economic growth to the lowest tax bidder. But the decision on where to locate is based on more important economic factors than taxes, such as distance from suppliers and markets, and the availability of skilled workers. It's also worth remembering that the few businesses that might actually be attracted by low taxes are likely to be low-paying, low-employment industries with little loyalty to the community and its long-term well-being.

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[14] Testimony before the United States Senate Finance Committee, January 18, 2001.

[15] *New York Times*, November 8, 2001.

[16] *Washington Post*, March 22, 1992, p.A22

Finally, it's important to remember that tax breaks don't buy loyalty from companies. Many states and communities have given huge tax breaks to large companies for years, only to have the company shut down the local plant for reasons unrelated to taxes.

Ensuring Accountability in Economic Development Strategies

Even if there is little evidence that tax policy affects economic growth, state lawmakers will continue to pursue potentially damaging tax breaks in an effort to spur economic growth in their state. How can lawmakers achieve the greatest "bang for the buck" from these tax breaks, while ensuring that the footloose corporations receiving these breaks won't take them to the cleaners? The Washington-based nonprofit watchdog group Good Jobs First focuses on issues of economic development accountability, and has recommended a variety of best practices for lawmakers enacting tax breaks, including:

- **Disclosure**, for each company receiving tax breaks, of how much the tax breaks cost and what public benefits resulted from the tax breaks. For example, lawmakers should be able to determine how many jobs were created as a result of the tax breaks and whether the jobs created are "good jobs" in terms of the wage and benefit structure. This information should be made publicly available and frequently updated.
- **Strict job quality standards** should be applied to any tax breaks designed to increase in-state employment. Requiring these new jobs to provide a basic "living wage" along with health care benefits helps to avoid imposing hidden taxpayer costs on state government. If a tax break results in a company hiring employees who are paid so little that they qualify for food stamps, Medicaid, or other taxpayer-funded social supports, the cost of the tax break may exceed its benefits to the state.
- **Money-back guarantees** that companies receiving tax breaks to create new jobs will actually create these jobs—and that the jobs will remain in the state for some specified period of time. These guarantees, known as "clawbacks," are now used by almost twenty states to ensure that lawmakers get enough "bang for the buck" out of these tax breaks.
- **Location-efficient incentives.** Tax incentives should encourage economic development in areas that are accessible to public transportation. This creates more opportunity for low-income families who cannot afford cars, and reduces traffic congestion.

Is Business the Enemy? (No)

Believing that companies and their shareholders should pay their fair share of taxes doesn't make one "anti-business." On the contrary, fair tax advocates fully understand the importance of a healthy economic climate for jobs and incomes. But governments must have the resources to provide the education, the roads, the sewer systems and other services that allow the economy to prosper. And unless those with the most ability to pay contribute their fair share, it will be virtually impossible for governments to provide these essential programs.

Precisely for this reason, not all corporations fight against progressive tax changes. Especially in states with low taxes, businesses may support progressive tax increases in order to improve the quality of government services. When Virginia lawmakers passed a billion-dollar tax hike in 2004, for example, it was with the blessing of the state Chamber of Commerce.

Even in states where many companies, and perhaps even the organized corporate lobby, oppose fair taxes, there may be some sectors of the business community that favor progressive tax reform. Often the organized business lobby is dominated by a few large corporations that may have very different interests than do small- and medium-sized businesses. These corporations can be an essential partner in progressive coalitions seeking to achieve tax adequacy and fairness. These partnerships are discussed in more detail in Chapter Eleven.

CHAPTER TEN
OTHER STEPS TOWARD (OR AWAY FROM) FAIR TAXES

Tax reform is not just about changing the base and the rates of particular taxes. Lawmakers around the nation have enacted procedural changes in the way tax breaks and proposed tax changes are reported and evaluated, as well as rules governing the way taxes are collected and rebated. This chapter looks at several such reforms and discusses their impact on the quality of state and local tax systems.

Tax Expenditure Reports

Lawmakers often provide targeted tax cuts to particular groups of individuals or corporations. These special tax breaks are called "tax expenditures" because they are essentially government spending programs that happen to be administered through the tax code. However, tax expenditures are usually less visible than other types of public spending—which makes it harder for policymakers and the public to evaluate these hidden tax breaks.

The main difference between tax expenditures and regular government spending is that under the tax expenditure approach, instead of the government sending out a check to the recipient, the recipient pays less in tax. For example, a government could create a direct spending program to subsidize windmill construction. Or, instead, it could offer a tax expenditure that lets companies building windmills reduce their taxes by exactly the same amount. In theory, it doesn't matter whether a government uses direct spending or a tax expenditure to achieve a policy goal.

In practice, however, tax expenditures differ from direct spending in several important ways.

- Unlike most spending programs, tax expenditures are usually open-ended; they have no built-in budget limits, and generally there is no annual appropriations or oversight process.
- Tax agencies typically have little incentive to ensure that tax-expenditure programs are working as they were hoped to. By contrast, government agencies tend to look closely at the effectiveness of their direct spending initiatives.
- Basic facts about who benefits from tax expenditures are often hidden behind the cloak of tax return secrecy, unlike the beneficiaries of conventional spending programs.

As a result, tax expenditures often turn out to be very expensive programs for which there is little oversight. Once a tax expenditure is put into the law, it usually stays there indefinitely. And typically little is known about what the government is getting—if anything—for its money.

In most states, lawmakers don't know how much is being spent on tax expenditures. Of course, tax collections are lower than they otherwise would be. But how much lower is a mystery.

In recognition of this problem, many states (and the federal government) now publish **tax expenditure budgets**. These are simply a listing of tax breaks and how much they cost.

A growing number of state governments have followed the federal government's lead by publishing tax expenditure reports of variable quality. The best reports include the following:

- A **complete list of all exemptions** from taxes levied by a state—including tax breaks (like exemptions of services from state sales taxes) that are not explicitly written in the tax code.
- **Estimates of the state and local revenue loss** from each tax expenditure, including estimates of how much the tax break is likely to cost in the future.
- Many state tax expenditures are inherited indirectly by state linkage to federal tax codes. Separately **itemizing these indirect federal tax breaks** will give policy makers a clearer understanding of the extent to which the federal linkage reduces state revenues.
- A written **evaluation of the effectiveness of each tax expenditure** will help policy makers to understand why each tax break was enacted—and how well it achieves its stated goals.

- A **regular publishing schedule** that coincides with the state budgeting process. State policy makers should be able to evaluate tax expenditure side-by-side with conventional spending.

Tax Incidence Analysis

Tax fairness is an important policy goal—and lawmakers frequently make bold claims about the impact of tax reform proposals on tax fairness. However, most states do not currently have the analytical capability to evaluate these claims—so the media, the public and even lawmakers are often left in the dark about the true impact of tax reform proposals. The best tool for evaluating the fairness of state taxes is tax incidence analysis, which measures the impact of various taxes on residents at different income levels. Only three states—Maine, Minnesota, and Texas—have legal requirements mandating the regular use of tax incidence analyses, although other states are currently developing a limited tax incidence analysis capability.

By developing a regularly-used tax incidence model capable of evaluating all of the major taxes levied at the state and local level, state lawmakers can increase the public's understanding of tax policy issues—and can help build public trust in elected officials. But until a regular tax incidence analysis capability is introduced, policymakers and the public will have no easily available basis for evaluating the fairness of important tax policy decisions. This increases the likelihood that lawmakers will be persuaded by false claims about the fairness of various proposals—and also makes it less likely that tax fairness will be a factor in tax policy decisions.

Rainy Day Funds

In the long run, states with progressive personal income taxes will enjoy the most reliable growth in tax revenues. But the recent decline of income taxes in many states has left policy makers jittery about the role of the tax in funding services. Some lawmakers have advocated making income taxes less progressive to help ensure the long-term adequacy of state revenues.

This is, however, a red herring. The real culprit in states suffering from income-tax shortfalls in recent years is the unwillingness of states to save sufficient revenue in good years to devote to shoring up revenues in lean years. Almost all states now have some form of "Rainy Day Fund" designed to achieve this—but the recent economic slowdown has exposed the design flaws of many states' funds. The box at right shows some of the most important factors differentiating effective and ineffective rainy day funds. Important questions to ask about your state's rainy fund include:

Important Features of Rainy Day Funds

- ✔ **Rules for deposits**
- ✔ **Size limits**
- ✔ **Rules for withdrawals**
- ✔ **Rules for replenishing funds**

- Under what circumstances must lawmakers deposit revenues into the fund? Requiring annual deposits when revenue growth exceeds a certain threshold is a good approach.
- Is there a limit on the size of the fund? Many states limit their rainy day fund to five percent of annual expenditures or less—a figure that most now agree is too low.
- How hard is it to withdraw funds? Excessive constraints on withdrawals make the rainy day fund less flexible as a fiscal policy tool.
- How quickly must the fund be replenished after a withdrawal? The faster the replenishment rule, the less flexible rainy day funds are in dealing with fiscal shortfalls.

Rainy day funds are a necessary component of a responsible state budget for a simple reason: taxes and public spending operate on different cycles. When the economy slows down, tax revenues slow down too. Declining income means declining income taxes and declining sales taxes as families make fewer purchases. But the need for important public services such as education and transportation does not diminish when the economy declines: declining income

actually *increases* the need for many areas of public spending, such as health care and low-income tax relief. Rainy day funds are an important way of allowing states to match up taxes and spending needs over the business cycle. Almost every state has recognized this reality by enacting a rainy day fund—but few states have created a fund that is truly adequate to bridge fiscal shortfalls.

Tax and Expenditure Limits (TELs)

A growing number of states now limit revenue growth by placing strict limits on the annual growth of state or local tax revenues or spending. These limits are collectively known as tax and expenditure limits, or TELs. One example of these limits is Colorado's Taxpayer Bill of Rights (TABOR). Colorado's TABOR limits the annual growth in state revenues to the sum of inflation and population growth. So if Colorado's population grows by 1 percent and inflation grows by 2 percent in a given year, Colorado government revenues are allowed to grow by no more than 3 percent in that year. "Surplus" revenues over that limit are rebated directly to taxpayers.

So what's wrong with a TABOR-style limit on state revenues and spending?

- When states collect revenue above the limit, this so-called "surplus" must be rebated to taxpayers. This makes it harder to replenish rainy day funds—which means that when the economy tanks, these states may have to enact painful spending cuts to make ends meet.
- Imposing a spending limit assumes that states are already adequately funding public services. Few state lawmakers would assert with a straight face that their public service needs have all been met—but that's one implication of strictly capping the growth rate of a state's spending.
- Spending limits assume that the cost of providing existing services will grow no faster than the limits allow. But many state spending needs grow faster than population and inflation, as any state lawmaker confronting skyrocketing Medicaid enrollment and education expenses can attest. And some public sector spending—spending on corrections facilities, for instance—can grow faster than spending limits for reasons that are beyond the control of lawmakers.
- Spending limits also assume that no new and unanticipated spending needs will emerge. The states' recent experience with homeland security expenditures attest to the constantly changing mix of spending priorities at the state level.

TABOR limits are often described by their proponents as a good-government tool. But state bond rating agencies, arguably the best arbiter of state fiscal health, reject this argument. In 2002, Standard and Poor's downgraded Colorado's bond rating, citing the TABOR spending limits as a reason for this punishment. And Colorado policymakers are now engaged in a heated debate over whether their TABOR limit should be modified or repealed entirely.

Across the nation, state lawmakers are facing painful decisions between further spending cuts and unpopular tax increases. TABOR-style spending caps restrict the ability of lawmakers to make the bread-and-butter decisions about government activities that should be their primary function, forcing the elimination of needed public services at the very time when they are most needed.

Good Choices, Bad Choices

Some of the structural reforms outlined in this chapter can have a positive impact on the ability of lawmakers to make reasoned, fully informed decisions about tax fairness and adequacy. Tax expenditure reports are an important tool to help citizens evaluate targeted tax breaks that would otherwise be hidden from public view. Tax incidence analysis makes it possible to accurately judge the fairness of tax reform proposals. And an adequate rainy day fund can allow states to weather the storm of economic recessions without cutting public services to the bone. But the arbitrary tax and spending limits collectively known as TELs actually add a new layer of complexity to the already difficult decision-making process facing legislators, making it much harder for policy makers to provide the services demanded by their constituents.

CHAPTER ELEVEN
FIGHTING THE FIGHT

Progressive tax reform may seem like a daunting task. After all, successful tax reform can take years—and progressives often are too busy fending off the unfair "tax deform" strategies of anti-tax organizations and lawmakers to embark on their own constructive agendas. But the good news is that the road to a fairer tax system is clearly marked. This chapter looks at important strategies and information sources for progressive tax advocates seeking to follow this road.

Strategies for Progressive Tax Reform

The first step in achieving state tax reform is to **understand what's wrong with your state's tax system**. This report has described in general language the structural flaws that plague almost all states' taxes—such as narrow sales tax bases and corporate tax loopholes. But there is no substitute for a good understanding of exactly which provisions of your state's tax laws prevent the state from achieving a fair and adequate tax system. The resources described later in this chapter can help you to learn more about the specific flaws in your state's tax structure.

In describing your proposals for tax reforms to fix these structural flaws, it's important to **be specific about what your plan does and how it affects people**. If your plan includes a vaguely stated proposal to raise income taxes on the rich, tax reform opponents will claim that by "rich" you mean anyone with a job. But if you make it clear that (for example) your plan would raise the tax rate on those with incomes over $200,000 by 5 percent in order to pay for a tax cut for those earning under $50,000, and would result in a tax cut for 60 percent of your state's residents, you'll have the kind of clearly stated proposal that will be difficult for the other side to distort.

Unfortunately, even clearly-defined tax reform plans can be smeared by scare tactics. So it's important to **be prepared to respond to misleading arguments** against your plan. For example, opponents of tax reform frequently claim that raising taxes on the wealthy or corporations will drive businesses away from a state and cost jobs. Or they will falsely claim that tax reform would increase taxes on middle-income families. These arguments are usually based on conjecture rather than research, and when there is "research" to back these claims up, it is often poorly designed. (See Chapter Nine for more on how to evaluate these anti-tax claims.) The goal of these scare tactics is not to inform voters—it's to make tax issues seem harder to understand than they really are, and to create confusion about what a reform proposal really does. So it's important to recognize and debunk specious arguments against progressive tax reform.

For example, it's important to remember that tax fairness means asking people to pay according to their ability and that incidence tables are the best measure of what is fair. Of course, your opponents will try to undermine incidence analyses. They might claim, for instance, that the top fifth of the population pays some high percentage of the total tax burden and that it wouldn't be "fair" to make them pay more. But this argument is nothing but a smoke screen. What really matters is the share of income paid in tax by taxpayers at different income levels—and by this basic measure of fairness, the wealthiest residents in most states pay substantially less than lower- and middle-income taxpayers.

It's also important to **highlight the linkage between the taxes you want to reform and the public services that are provided by these taxes**. If you ask most people whether they favor raising the state income tax, they'll probably say no. But if you ask people whether they favor raising the income tax to help fund education or health care, they will be much more supportive. Most people understand intuitively that the public services they value can only be provided if the tax system raises adequate revenues to pay for them—so it's important to remind people that the ultimate purpose of tax reform is to ensure the continued provision of these services.

Successful tax reform campaigns should **include organizations from many sectors of the community**. Unions, religious groups, public interest organizations, business groups and others should all be part of the campaign. Certainly, with more groups, there will be more conflict over the campaign's goals and tactics. But without broad participation, it is very difficult to overcome the power of those who oppose reform.

A winning tax reform agenda must also have an **educational component**—and these educational efforts must use simple, easily understandable language. State tax fairness and adequacy are important goals—but are also too complicated for most members of the media, state legislatures, and the public to understand intuitively. State tax advocates must make an effort to explain tax fairness issues to newspaper editorial boards, reporters, and lawmakers of all stripes. Equally important is presenting basic information on tax reform to the general public. Public workshops on tax reform can be a critical component in building public awareness of—and support for—progressive tax reform.

When these strategies are followed, successful tax reform efforts can be the result. For example, in recent years Alabama Arise and the Virginia Organizing Project each helped to build broad-based coalitions in their states. These groups developed plans for progressive tax reform, publicized which income groups would see increases or cuts in taxes as a result of their proposals, and worked with legislators and the media to help these groups understand the basic tax policy principles underlying their proposals. They also helped to lay the groundwork for public acceptance of tax reform by holding public workshops to explain basic tax fairness issues. This ongoing work helped to establish these groups as a credible source of accurate incidence, and made these coalitions a respected voice in state tax policy debates. The work of these coalitions also helped to increase the visibility of tax fairness issues in both states.

Resources for Further Investigation

There are many sources of information on state taxes. A good place to start is with the reports issued by ITEP and **Citizens for Tax Justice** (CTJ). ITEP analyzes the fairness of state and local taxes in dozens of states annually. ITEP's ***Who Pays?*** report (2003) provides a baseline for measuring the fairness of taxes in all fifty states. CTJ monitors the fairness of federal tax reform proposals ; CTJ's analyses of the Bush tax cuts were the most widely cited measuring-stick for evaluating the unfairness of these cuts. CTJ and ITEP also have published a series of analyses of corporate tax avoidance, most recently ***Corporate Income Taxes in the Bush Years*** (2004).

Just Taxes, our quarterly newsletter, keeps readers informed on the latest developments in tax policy and advocacy, and lists new publications of note by CTJ, ITEP and other organizations.

Other good sources for information on state taxes include:

- **State revenue and tax departments.** Many states publish reports that provide valuable information about the state's tax structure. Usually, the best place to start is with your state tax agency's annual report—but be sure to check out a complete list of available publications. Tax departments also often have a great deal of unpublished information. If there's something you need but can't find in an agency's publications, give the agency a call and ask for it. You can access the websites of these agencies on ITEP's website at www.itepnet.org/linkileg.htm.
- **State advocacy and research groups** are an essential component to any successful movement for tax fairness. These groups can be found in most states. ITEP maintains a list of these groups, organized by state, on our website at www.itepnet.org/linkistg.htm.
- The **U.S. Census Bureau** publishes *Government Finances*, a helpful source of data for comparing your state's tax system to other states. Census reports are available at www.census.gov.
- The **Center on Budget and Policy Priorities** publishes a wealth of information on tax and spending programs as they affect low-income taxpayers. Their website is www.cbpp.org.

- The **National Conference of State Legislatures** has a number of publications evaluating state taxes, including their annual ***State Budget and Tax Actions***. Their website is www.ncsl.org.
- The **Rockefeller Institute** regularly analyzes trends in the health of state tax systems, and follows trends in state spending as well. Their website is www.rockinst.org.

Final Thoughts

The need for progressive tax reform is now greater than ever. Even before the recent economic slowdown began, state and local taxes in almost every state were regressive. And most of the states that have managed to push through revenue-raising measures to respond to recent budget deficits have done so in a way that makes their tax systems even less fair—hiking regressive sales and excise taxes much more frequently than progressive income taxes. Meanwhile, as this report has documented, the structural flaws that have reduced the yield of these taxes remain unresolved:

- State and local sales tax bases are too narrow: few states have expanded their tax base to include services, the fastest-growing area of consumption. And many states have a host of poorly-targeted exemptions for the sales of various goods that reduce the yield of each penny of tax. Collectively, these tax breaks put added pressure on lawmakers to increase the sales tax rate on the remaining items of consumer spending.
- Personal income taxes, ostensibly the most progressive tax levied by states, are being eroded away—and made less progressive—by a proliferation of poorly targeted tax breaks for capital gains, retirement income and other income sources. And many states use income tax brackets that require a large percentage of taxpayers to pay at the top rate, rather than subjecting only the wealthiest taxpayers to the highest rates. These structural flaws mean that most state income taxes are not living up to their potential as a progressive offset for the regressive sales and property taxes that states rely on most.
- Corporate income taxes continue to decline, as federal and state tax breaks and clever accounting tricks by the corporations themselves make the tax base ever narrower.
- Property taxes remain an important, but unfair revenue source for state and local governments. Many states have enacted overly restrictive tax limits designed to reduce the use of these taxes, but relatively few have enacted well-targeted exemptions or credits designed to reduce the property tax on the low-income taxpayers for whom these taxes are most burdensome. And many states have not yet dealt with the inequities between low-wealth and higher-wealth taxing districts that the local property tax usually creates.

Events at the federal level have compounded these inequities: in the last four years alone, the wealthiest taxpayers have seen their effective tax rate decline substantially, while lower- and middle-income taxpayers have failed to reap similar gains. And corporate income taxes are nearing an all-time low. These unaffordable federal tax cuts have had the predictable impact of forcing cuts in important federal services, and cutting aid to state and local governments.

With the political paralysis and the knee-jerk fear of taxes so often found in Congress and state houses throughout the country, the task of igniting tax reform falls on tax activists. We do have one important thing going for us: most people *want* fair and adequate taxation. The key is showing the public, elected officials and the media what fair tax policy is and how it can benefit the people of our nation. We hope this primer provides you with enough tax policy knowledge to start that process.

GLOSSARY

Adjusted gross income (AGI). On an personal income tax form, the amount of income that is subject to tax after all adjustments have been taken, but before subtracting deductions or exemptions. (Chapter 5)

Adjustments. Income tax breaks that reduce the amount of taxable income. For example, on federal income tax forms moving expenses, some teaching supplies, and contributions made to certain retirement plans are subtracted from income. Most states allow the same adjustments that are allowed on federal forms, and many allow their own unique adjustments. These adjustments are often enacted with good intentions, but tend to make the income tax more complicated than it needs to be. (Chapter 5)

Ad valorem tax. A tax based on the value of the thing being taxed. Sales taxes are based on the sales price of items taxed, so they are ad valorem taxes. Cigarette taxes are not ad valorem taxes, because they are levied on a per-pack basis, so tax collections do not vary with the price of a pack of cigarettes.(Chapter 3)

Apportionment formula. The formula states use to divide up the profit of a multi-state corporation into an "in-state" portion and an "out-of-state" portion. In theory, apportionment rules should divide a corporation's income between the states in which it earns profits in such a way that all of its profit is taxed exactly once, but special apportionment rules mean that some profits are never taxed at all. (Chapter 6)

Assessed Value. The official value of a property for tax purposes, as determined by property tax officials. A property's assessed value can be equal to its market value, or less than market value, depending on the legal assessment ratio used by the state and the quality of assessments. (Chapter 4)

Bracket Creep. When income tax brackets are not adjusted frequently to account for the impact of inflation, taxpayers can see income tax hikes over time even if their real income doesn't grow. These inflationary tax hikes can affect any income tax variable that is defined as a fixed dollar amount, including exemptions and credits, and can also reduce the value of property tax breaks. (Chapters 4, 5)

Business Input Sales. The sale of items purchased by businesses to create their products. For example, a baker purchases flour to make bread. The baker's purchase of flour is a business input sale. Retail sales taxes should not apply to such sales—but most state sales taxes do so to some extent. (Chapter 3)

Circuit Breakers. A form of targeted property tax credit. Typically, states give homeowners a credit equal to the amount by which their property tax exceeds a certain percentage of their income. Most states target their circuit breakers to elderly homeowners, but an increasing number of states use them to deliver tax relief to non-elderly taxpayers and to renters. (Chapter 4)

Consumption Tax. A tax that applies to purchases of goods and/or services by individuals and businesses. These taxes include general sales taxes, which apply to retail sales, and special excise taxes on alcohol, cigarettes, and gasoline. (Chapter 3)

Credit. A dollar amount subtracted from tax liability. (By contrast, deductions and exemptions are subtracted from taxable income.) Tax credits are used primarily to reduce income and property tax liability, but are occasionally used to partially offset the regressivity of sales taxes. In general, credits are a more progressive approach to tax relief than are exemptions. (Chapters 3, 4, 5)

Effective Tax Rate. The tax burden as a share of the potentially taxable base. For example, the effective income tax rate is the income tax paid expressed as a share of total personal income. (Chapter 2)

Excise Tax. Sales taxes that apply to particular products. For example, many states levy excise taxes on alcohol, cigarettes and gasoline. Excise taxes are especially regressive because the tax is levied on a per-unit basis (so the tax on a bottle of cheap wine is the same as the tax on an expensive wine). (Chapter 3)

Exemptions. A special rule that provides a tax shelter for some economic activity. Exemptions reduce the amount of taxes owed. Income taxes usually allow exemptions for each taxpayer, and property taxes often allow part of a home's value to be exempted from tax. Sales taxes frequently exempt all sales of certain items such as food, utilities and rent. (Chapters 3, 4, 5)

Exported Tax. The amount of a tax paid by out-of-state residents. Some part of almost every state tax is paid by residents of other states. This helps ensure that non-resident individuals and businesses that use a state's services pay their fair share of the cost of providing these services. (Chapter 2)

Graduated Tax. A graduated tax applies higher tax rates to higher income levels. Most income taxes use graduated rate structures. By contrast, a flat-rate tax applies the same rate to all incomes. (Chapters 1, 5)

Homestead Exemption. A tax break used to shelter a certain amount of a homeowner's property from the property tax. (Chapter 4)

Incidence Analysis. A tool for measuring the fairness of state and local taxes and tax changes. (Chapter 2)

Intangible Property. Property that has no physical substance, but may have financial value. Examples of intangible property include stocks, bonds, and retirement plans. (Chapter 4)

Marginal rate. Income tax rates that apply only to the taxable income over the amount where the tax bracket starts. (Chapter 5)

Nexus. The minimum level of contact that a business must have with a state in order for its activities to be taxable in that state. (Chapters 3, 6)

Progressive. A progressive tax is one in which upper-income families pay more of their income in tax than do those with lower incomes. (Chapter 1)

Public Law 86-272. A federal law restricting the ability of states to tax multi-state businesses under their corporate income tax. PL 86-272 holds that states cannot tax businesses whose only connection to the state is shipping products into it. (Chapter 6)

Pyramiding. Sales taxes are supposed to apply only to consumer purchases. When these taxes also apply to business-to-business transactions during the production process for a retail product, that sales tax is usually built into the final purchase price of the product. Since this built-in sales tax is itself subject to the retail sales tax, taxing early stages of the production process has a "pyramiding" or "cascading" effect on the total amount of sales tax we pay on any retail purchase. (Chapter 3)

Regressive. A regressive tax requires low- and middle-income families to pay more of their income in tax than wealthier families must pay. (Chapter 1)

Remote Sales. Purchases of items from companies based in other states. Every state with a sales tax also levies a use tax designed to tax these remote sales. (Chapter 3)

Retail sale. A sale made to the final consumer of a product. When we buy a new refrigerator for personal use, that's a retail sale. By contrast, when a business buys lumber for use in building a house, that's not a retail sale but an *intermediate transaction*, because the goods purchased are used in the process of making something else. In theory, states should tax all retail sales and exempt all intermediate transactions, but almost all states fall short of both of these goals. (Chapter 3)

Tangible Property. Property that has physical substance and can be touched. This includes real property such as homes and apartments, and personal property such as cars and furniture. (Chapter 4)

Tax Base. The amount subject to tax. If all the consumers in a state purchase $1,000,000 in coffee each year, then the tax base for a coffee sales tax would be $1,000,000. However, the tax base does not have to be expressed in terms of money. If coffee was taxed by the pound, then the tax base would be the number of pounds of coffee sold. (Chapter 2)

Tax Expenditure. A special tax break targeted to particular groups of individuals or businesses. These tax breaks have the same impact as a direct government spending program giving cash grants to these groups, but implementing them through the tax system makes these grants less visible—and makes lawmakers less accountable for explaining why these breaks are a good idea. (Chapter 10)

Uniform Division of Income for Tax Purposes Act (UDITPA) . Model legislation adopted in the 1950s by legal reformers seeking to achieve fairness and uniformity in state corporate tax practices. Most states initially adopted at least some of the UDITPA recommendations, but many have moved away from UDITPA recommendations by changing apportionment factors and other rules. (Chapter 6)

Use Tax. A sales tax which applies to goods that are purchased from out-of-state retailers. (Chapter 3)

Vertical equity. The measure of tax fairness that describes how a tax system treats people at different income levels. When we describe a tax as regressive, proportional or progressive, we're making a statement about vertical equity. (Chapter 2)

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Property Taxes and Elderly Mobility

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Abstract

The recent housing market boom in the U.S. has caused sharp increases in residential property taxes. Housing-rich but income-poor elderly homeowners often complain about rising tax burdens, and anecdotal evidence suggests that some move to reduce their tax burden. There has been little systematic analysis, however, of the link between property tax levels and the mobility rate of elderly homeowners. This paper investigates this link using household-level panel data from the Health and Retirement Study (HRS) and a newly collected dataset on state-provided property tax relief programs. These relief programs generate variation in effective property tax burdens that is not due solely to arguably endogenous local community choices about taxes and expenditure programs. The findings provide evidence suggesting that higher property taxes raise mobility among elderly homeowners. The point estimates from instrumental variable estimation using relief programs to generate instruments suggest that a $100 increase in annual property taxes is associated with a 0.76 percentage point increase in the two-year mobility rate for homeowners over the age of 50. This is an eight percent increase from the baseline two-year mobility rate of nine percent. These results are robust to alternative specifications.

Keywords: Property tax, Elderly mobility, Property tax relief program
JEL classification: H31, H71, R21

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1 Introduction

During the late 1990s and early 2000s, the housing market in the United States experienced a remarkable boom. As housing prices increased, property taxes rose significantly in many parts of the country. Increases in property taxes have drawn attention from both the general public and policy makers. The public and politicians are particularly concerned that elderly homeowners who live on fixed incomes will be driven out of their homes because they can no longer afford increasing property taxes. In response, many states are looking for new ways of providing property tax relief to elderly homeowners. Although policy makers have assumed that rising property taxes cause elderly homeowners to move, researchers have provided little empirical evidence of such a link.

Apart from its policy implications, studying property taxes' effect on elderly mobility is also of great economic importance. The simplest version of the life-cycle model, which assumes away capital market imperfection, transaction costs, bequest motives, and uncertainty, predicts that utility-maximizing agents accumulate wealth while working and deplete wealth after retirement. If elderly homeowners view their housing wealth as a part of retirement savings to be used for general consumption, then we would expect elderly homeowners to trade down and consume their housing wealth after retirement. However, studies including Feinstein and McFadden (1989) and Venti and Wise (1989, 1990, 2001) find little evidence of downsizing behavior among elderly homeowners in the absence of precipitating shocks such as health decline and loss of spouse. Because residential mobility is directly linked to housing adjustment and downsizing decisions, studying how factors such as property taxes affect elderly mobility may help us build richer models to describe household life-cycle saving and consumption patterns.

Despite its policy and economic significance, the question whether property taxes

have caused elderly homeowners to move is difficult to address empirically for two reasons. First, reliable household-level measures of property tax payments and mobility outcomes are scarce. Hence, many earlier studies use aggregated measures such as property tax per capita and state to state or county to county migration flows. These studies include Cebula (1974), Clark and Hunter (1992), Dresher (1994), Conway and Houtenville(2001), and Duncombe et al (2003). Second, property taxes are likely to be endogenous to individuals' moving decisions. For example, many local public services are financed through property taxes. Hence, elderly homeowners who value local public services (e.g. nice parks, low crime rates, and new senior centers) are likely to live in areas with high property taxes. Because tastes for local public services may be correlated with mobility outcomes and because econometricians do not observe individual tastes, studies that fail to instrument for property taxes often suffer from omitted variable bias.

In this paper, I use the 1992 to 2004 waves of the Health and Retirement Survey (HRS) panel data. This dataset has household-level measures of property tax payments and mobility outcomes in addition to extensive information on demographics and socio-economic characteristics. To address the endogeneity problem associated with property taxes, I exploit the variation in state-provided property tax relief programs and use simulated relief benefits to instrument for property tax payments. By construction, these simulated relief benefits contain only the variation in program rules and depend exclusively on state of residence, year, and age of homeowners. More generous relief programs reduce property tax payments of eligible homeowners, and these state-provided programs are arguably exogenous to individual homeowners' unobserved tendency to move. Therefore, simulated relief benefits serve as a valid instrument for property taxes in studying elderly mobility.

I also use the variation in effective property tax rates and housing value appreciation rates as an alternative strategy to study whether higher property taxes cause elderly

homeowners to move. The thought experiment is to compare two observably identical homeowners, one living in a place with a high effective property tax rate and the other living in a place with a low effective property tax rate. When housing values in both places go up, the person who lives in the area with a high effective tax rate will experience a larger increase in property taxes. Thus, he would be more likely to move if property taxes affect homeowners' mobility. The key identification assumption here is that in the absence of a property tax effect, mobility in areas with high effective tax rates responds to rising property values the same way as mobility in areas with low effective tax rates, after controlling for observable characteristics. For example, if increases in housing wealth affect mobility, this identification strategy assumes that such a wealth effect is symmetric for homeowners in both areas with high effective tax rates and areas with low effective tax rates.

I find that higher property taxes have a significant impact on elderly homeowners' moving decisions. My central instrumental variable estimates suggest that a \$100 increase in annual property taxes causes the two-year mobility rate to increase by 0.76 percentage points, which represents an eight percent increase from a baseline two-year mobility rate of nine percent. The results are robust to various model specifications. Individuals living in areas where the effective property tax rate is high and housing values have been appreciating rapidly are the most affected. Moreover, I find mixed evidence on whether liquidity constraints may play a role in the effect of property taxes on elderly mobility. This paper's findings provide indispensable evidence for normative welfare analysis of the impact of property taxes and property tax relief programs on elderly homeowners.

This paper proceeds as follows. The next section outlines the background and reviews previous research on property taxes and elderly mobility. Section 3 then describes the data used in this paper. In section 4, I explain the empirical strategies that I use to identify the effect of property taxes on elderly mobility. I also show estimation results using these

strategies. The last section concludes and provides directions for future research.

2 Background and Previous Research

In 2004, property tax collections in the U.S. exceeded $300 billion. Property taxes are responsible for approximately 72% of all local tax revenues, representing the most important tax revenue source for local governments.[1] The housing market boom of the late 1990s and early 2000s led to significant increases in residential property taxes. Figure 1 shows that from 2000 to 2005, median house value rose by 47% in real terms and median property tax payments by homeowners increased by 30%.[2]

Rising property taxes may be particularly burdensome to elderly homeowners. Following notations in Poterba (1992), the user cost faced by a homeowner under the current U.S. tax system can be written as

$$uc = \begin{cases} (1-\tau_{inc})[\tau_p + \alpha i + (1-\alpha)r] + m + \delta - \pi^H & \text{for itemizers} \\ \tau_p + \alpha i + (1-\tau_{inc})(1-\alpha)r + m + \delta - \pi^H & \text{for non-itemizers} \end{cases}$$

where τ_{inc} is the homeowner's marginal income tax rate, τ_p is the effective property tax rate, α is the loan to value ratio on the house, i is the mortgage interest rate, r is the interest rate on alternative investment opportunities, m is the maintenance cost rate, δ is the true economic depreciation rate, and π_H is the housing value appreciation rate. One measure of property tax burden on homeowners is the ratio of property tax rates to user costs. For

[1]See Bradley (2005) and NCSL (2005).

[2]A number of factors could have contributed to the increase in residential property tax payments, including unfunded federal mandates, reduction in state aid to local governments, changes in the cost of providing local public services, and relative appreciation rates of residential versus non-residential properties. Although interesting in its own right, it is beyond the scope of this paper to determine which factors explain the property tax increases the most.

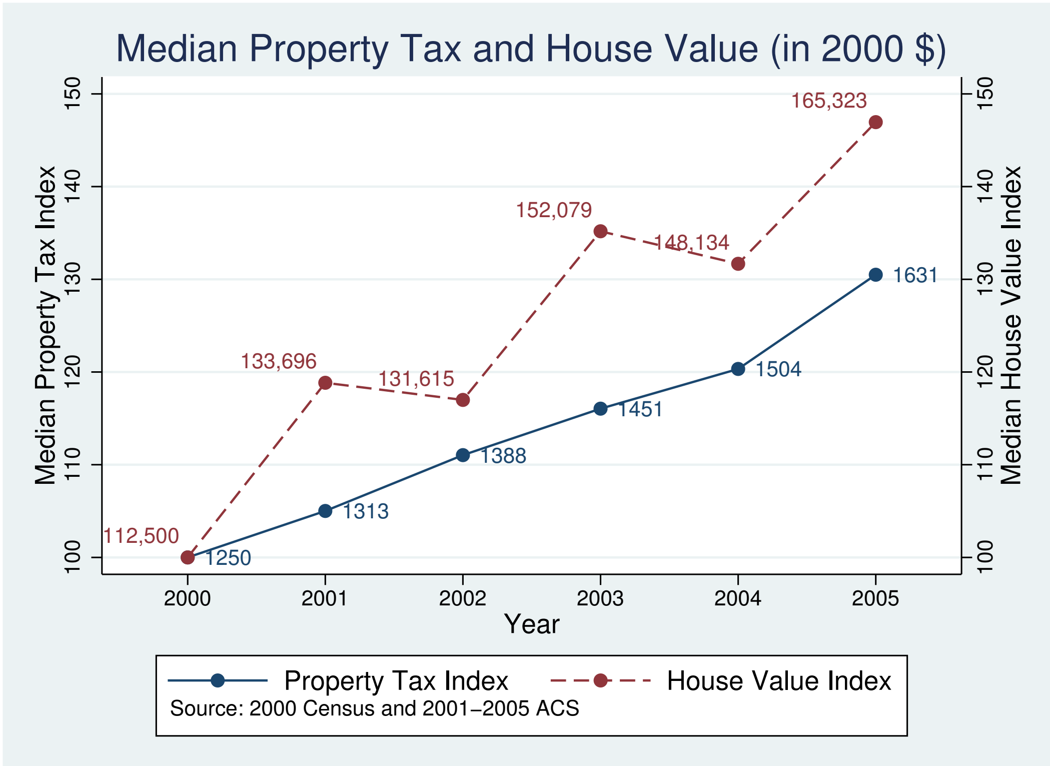

Figure 1: Recent Trends in Property Taxes and House Values in the United States

itemizers and non-itemizers, the ratios are

$$burden = \begin{cases} \dfrac{(1-\tau_{inc})\tau_p}{(1-\tau_{inc})[\tau_p + \alpha i + (1-\alpha)r] + m + \delta - \pi^H} & \text{for itemizers} \\ \dfrac{\tau_p}{\tau_p + \alpha i + (1-\tau_{inc})(1-\alpha)r + m + \delta - \pi^H} & \text{for non-itemizers} \end{cases}$$

According to the 2004 Survey of Consumer Finances, the median homeowner of age 65 or above is a non-itemizer who faces a marginal tax rate of 15% and who has paid off his mortgages. In contrast, the median homeowner of age below 65 is an itemizer with a marginal tax rate of 25% and a loan to value ratio of 0.5. Assuming that $\tau_p = 0.01$, $i = 0.08$, $r = 0.05$, $m = 0.02$, $\delta = 0.02$, and $\pi^H = 0.03$, we have $burden_{nonelderly} = 0.12$ and $burden_{elderly} = 0.19$. If we assume elderly homeowners spend less on home maintenance than non-elderly homeowners as suggested by Davidoff (2007), the property tax burden on

elderly homeowners would appear even higher than that on non-elderly homeowners.

State and local governments may be concerned that elderly homeowners in the face of rising property tax burdens decide to relocate to areas with low property taxes. Given that around half of property tax revenues are used to finance public schools and that elderly homeowners usually do not consume school services, elderly homeowners may find that the local public services that they receive are not worth their costs. In response, they decide to adjust their housing consumption bundles and relocate to areas with both fewer public services and lower property taxes. Precisely because elderly homeowners in general consume fewer public services but expand the state and local tax base, they are attractive to state and local governments except when they reach the end of their lives and demand expensive medical care services through Medicaid. They are even called "pure gold" in Longino and Crown (1989). As discussed in Mackey and Carter (1994), many states in the U.S. provide a wide range of tax preferences to entice elderly migrants.

Alternatively, increasing property taxes may raise mobility rates among elderly homeowners through liquidity constraints. Because the elderly typically rely on fixed incomes such as Social Security benefits and pension benefits, and because many of them do not have many liquid assets, rising property taxes may cause elderly homeowners to be liquidity-constrained. Even if an elderly homeowner has great psychological attachment to his house and prefers not to move as long as he can afford it, significant increases in property taxes may eventually cause the homeowner to liquidate his housing wealth. This liquidity constraint mechanism and the demand adjustment mechanism mentioned earlier have very different welfare implications as to whether property tax relief programs should be provided by state and local governments.

A few papers investigate property taxes and elderly mobility using household-level data. The studies closest to this paper are Farnham and Sevak (2006) and Seslen (2005). The

former study is a test of a life-cycle Tiebout model using the 1992-2000 HRS data and local fiscal data. It finds that cross-state, empty-nest movers experience reduced exposure to local school spending and property taxes. Although their study examines both property taxes and elderly mobility, Farnham and Sevak (2006) addresses the question from a different angle than the current study. Their study focuses on testing whether property tax payments decline after an elderly homeowner makes a move, whereas my study asks whether rising property taxes induce elderly homeowners to move. Moreover, their paper presents a correlation study, while my paper tackles the causality question using instrumental variable strategies.

Seslen (2005) examines the effect of property taxes on elderly homeowners' downsizing decisions in a competing risk framework. Using the Retirement History Survey from 1969 to 1979, she finds little evidence that property taxes affect elderly homeowners' decisions to move and to liquidate their housing wealth. Thus, she concludes that property tax relief programs are likely to solely transfer resources to the wealthy without achieving the goal of protecting the needy. Although Seslen (2005) employs sophisticated econometric tools, the data she studies were collected about 30 years ago, and they may not bear on the current situation. She uses self-reported property tax payments as the key explanatory variable, but she ignores the potential endogeneity problem where some unobserved factor drives both property tax payments and mobility decisions.

My paper advances the prior literature in several ways. First, I use the HRS data, a nationally representative panel of elderly households that contains rich information on individual and household characteristics, including actual annual property tax payments. The panel structure also provides an opportunity for me to look at the dynamic relationship between the last period's property tax payments and the next period's mobility outcomes, which is impossible to do with cross-sectional data. Second, during my sample period, the United States experienced significant increases in property taxes. The recent trend of rising

property taxes provides a good opportunity to study the effect of property taxes on elderly homeowners' moving decisions. Third, I obtained access to the HRS restricted geographic identifiers and collected data on state-provided property tax relief programs for the past 15 years. With these data, I am able to calculate the amount of eligible property tax relief benefits for each household in each survey year. Lastly, I address the potential endogeneity problem using instrumental variable approaches. To my knowledge, this is the first study to examine the causal effect of property taxes on elderly mobility and to measure property tax relief benefits at the household level. The innovations in both data and estimation methodology allow this paper to present more compelling evidence than currently exists on the effect of property taxes on elderly mobility.

3 Data

3.1 HRS Household Level Panel Data

The Health and Retirement Study (HRS) is biannual panel data of the elderly and near-elderly in the United States. At present, seven waves of the survey (1992-2004) have been released to researchers. The HRS includes households from four different cohorts.[3] The original HRS cohort consists of individuals born between 1931 and 1941. They appear in all seven waves of my sample. The AHEAD cohort (born before 1924) was interviewed in 1993 first and then in 1995. Since 1998, the AHEAD cohort has been interviewed concurrently with the HRS cohort biannually. In 1998, two other cohorts were added to the sample: the "Children of the Depression" (CODA) cohort (born between 1924 and 1930), and the "War Baby" (WB) cohort (born between 1942 and 1947). Hence, these two cohorts appear only

[3] In 2004, a fifth cohort, Early Boomers (born between 1948 and 1953), was added to the HRS. Because households in this cohort have only been interviewed once and I need at least two adjacent surveys to study whether the last period's property taxes affect mobility in the next period, I exclude them from my analysis.

in the last four waves (1998-2004) in my sample.

In addition to the publicly available HRS data, I obtained restricted access to household level geographic identifiers. These identifiers allow me to identify the state of residence for each household at each survey interview time. The state identifier is crucial in my analysis because it links households with the state-provided property tax relief programs for which they are eligible. Because of the ambiguity associated with mobility for people living in mobile homes, I exclude them from my analysis. Because farms and ranches may be treated as agricultural rather than residential properties for property tax purposes, I also exclude people living on farms or ranches from my sample. Households residing in mobile homes or on farms and ranches combined constitute around 10 percent of the entire HRS sample. I also dropped individuals who are newly separated or divorced because mobility becomes complicated for these individuals. Newly separated or divorced homeowners represent less than 1 percent of the sample.

Except for the very first survey conducted on each household, every subsequent survey asks respondents whether they have moved since their last survey interview. I use respondents' answers as my mobility measure. I contacted HRS staff to confirm that this mobility measure is a valid and consistent measure across waves. Panel A of Table 1 displays the two-year mobility rates of the HRS cohort households from 1992 to 2004. In earlier years when those respondents were relatively young, their two-year moving probability was around 7%. Toward the end of the panel, the probability increases to 12%. In contrast, the average one-year mobility rate among homeowners of age below 65 is about 10% during the 1990s and early 2000s. Panel B of Table 1 shows that homeownership rates of HRS cohort households stay steady at around 80% during the 12-year sample period. Panel C of Table 1 presents a tenure transition matrix for all moves made by HRS cohort households between 1992 and 2004. Over 80% of homeowners remain homeowners after they relocate, and 70% of renters

stay renters after they move. In summary, Table 1 shows evidence consistent with the conclusion drawn by Venti and Wise (2001) that mobility rates among elderly homeowners are low, and that elderly homeowners do not seem to trade down and consume their housing wealth in the absence of precipitating shocks.

In all seven waves, respondents were requested to report the amount of property taxes paid on their primary residence during the past year. I assume the self-reported property tax payments are the actual payments *after* all relevant exemptions, rebates or refunds provided by relief programs have been applied. Such an assumption is crucial for the first-stage regression in my IV strategy. For programs where participation is automatic and property tax bills are mailed to homeowners after benefits have been netted out, this assumption seems justified. For programs where homeowners receive rebate checks soon after paying property taxes, it is unclear whether respondents report their before-relief property tax payments or after-relief property tax payments. For programs that are implemented by state personal income tax credits, respondents are likely to report their before-relief benefits for two reasons. First, relief benefits are usually received long after homeowners have paid their property taxes. Second, property tax relief benefits may appear less salient on state personal income tax returns. For example, filers may view property tax credits that they claim against income tax liabilities as *income tax* relief benefits rather than *property tax* relief benefits. Recent studies including Chetty, Looney and Kroft (2007) and Finkelstein (2007) suggest that tax salience could have a significant impact on behavior. Regression results presented in an earlier version of this paper suggest that respondents in states that use income tax credits to grant property tax relief benefits do not report lower property tax payments when they are eligible for more generous relief benefits. Therefore, I exclude in my main regression analysis states where relief benefits are granted by tax credits on state personal income tax returns.[4] The dropped observations represent about 25% of the

[4]These states are District of Columbia, Massachusetts, Michigan, Missouri, Montana, New Jersey, New

sample.

Table 2 presents the summary statistics of demographic and socio-economic variables. Note that only about 17% of moves in the sample are cross-state moves, which implies a 3.8% five-year cross-state mobility rate (i.e. $9 \times 0.17 \times (5/2) = 3.8$). This rate is very similar to what other studies on elderly migration find.[5] Given that the majority of moves are within-state relocations, results produced by studies focusing on cross-state mobilities could be misleading.

3.2 Data on Property Tax Relief Programs

3.2.1 Background on Property Tax Relief Programs

As of 2005, all 50 states and District of Columbia have some form of property tax relief programs for homeowners, especially for low-income and elderly homeowners. Many of these programs were first established well before my sample period started.[6] Broadly speaking, there are four categories of relief programs. The first includes *Homestead Exemptions and Credits*. This is the most widely used form of property tax relief. Homestead exemption programs usually reduce assessed property value by a certain amount.[7] Homestead credit programs either refund a certain percentage of taxes due or provide a fixed credit to qualifying

Mexico, New York, Oklahoma, Rhode Island, Vermont, and Wisconsin. I do not exclude states that use rebate checks to implement relief programs because the sample size would drop significantly and asymptotic theory no longer applies when there are only a few states left in the sample and standard errors are clustered at the state level.

[5] Woo (2005) states that the five-year cross-state mobility rate among elderly homeowners is 4.2% in the Census data and 4.0% in the Current Population Survey data.

[6] Homestead exemptions are believed to be a by-product of the Great Depression of the 1930s. Circuit-breakers were first legislated in the 1960s and 1970s. Limits were put in place in the late 1970s and early 1980s when high inflation rates caused property tax bills to spiral out of control and eventually resulted in property tax revolts.

[7] For example, a homeowner of age 65 or above in Kentucky was allowed to exclude $29,400 from the assessed value of his main residence for property tax purposes in 2005.

homeowners.[8] These homestead exemption and credit programs usually require homeowners to file an application to local property tax authorities.

The second category is *Circuit-Breakers*. Some of these programs are for homeowners only, and others are for homeowners as well as renters. Since these programs are designed to help people who need assistance, benefits are typically a decreasing function of income. Circuit-breaker programs can work either on a sliding scale or through a threshold mechanism. For example, District of Columbia has a circuit-breaker program where homeowners whose income is $20,000 or less can receive up to a $750 tax credit using a threshold mechanism. In 2007, Idaho's circuit-breaker program refunded up to $1320 for homeowners of age 65 or above with income below $28,000 using a sliding scale mechanism.[9]

The third category is *Property Tax Deferral Programs*. These programs allow qualified homeowners, typically low-income elderly homeowners, to defer property tax payments at a low interest rate. Effectively, they become a lien against the taxpayer's house. When the homeowner sells the house or dies, deferred taxes must be paid when the estate is settled. Deferral programs are considered by academics the most targeted and cost-effective way of providing property tax relief. Nevertheless, very few qualified homeowners take up such programs in practice. Anecdotal evidence suggests that elderly homeowners are reluctant to put a lien on their houses. This is consistent with the observation that very few elderly homeowners purchase reverse mortgages in the United States.

The last broad category is *Property Tax Limits*. Property tax limits include rate limits, assessment limits, revenue rollbacks, expenditure limits, and property tax freezes. De-

[8] For example, Massachusetts state statue Clause 17D and 41C grant a $175 homestead credit and a $500 homestead credit respectively to homeowners of age 70 or above who satisfy certain income, assets, and residence requirements.

[9] The key difference between homestead credit programs and circuit-breakers is that although homestead credit programs may use income as a qualification criterion, their benefit levels do not vary with income. On the other hand, benefits are explicitly a decreasing function of income for circuit-breakers. For this reason, circuit-breakers are considered better targeted at low and moderate-income individuals.

pending on the state, any one or a combination of the above limits can be used. Proposition 13 in California and Proposition 2.5 in Massachusetts are among the most prominent examples of property tax limits. Although almost all states have property tax limits of one kind or another, many of these programs do not guarantee that individual homeowners' property tax bills will not go up significantly from year to year. Because property taxes are the product of taxable values and tax rates, the amount of property taxes homeowners pay will be limited only when both assessment values and tax rates are limited. Rate limits or assessment limits alone are insufficient in curbing property tax growths. Moreover, states usually allow for override and bonded indebtedness so that local governments can still increase property taxes. For example, if non-elderly homeowners want to spend more on schools, they may approve an override, in which event the elderly will face rising property taxes. However, two kinds of limits apply to individual homeowners: "assessment value freezes" and "property tax freezes."[10]

Participation rates of property tax relief programs vary across states and programs. In mid-1990s, the American Association of Retired Persons (AARP) obtained numbers of program participants from various state administering offices and estimated participation rates for these programs.[11] The median estimated participation rate among the eligible is the highest for homestead exemptions - around 90%. In contrast, the median estimated participation rate is only about 40% for homestead credits and circuit-breakers and less than 1% for deferral programs. It is puzzling why participation rates for homestead credits and circuit-breakers are so low among elderly households. Some have suggested that social stigma and program complexity may play a role.[12]

[10]For example, in Illinois, homeowners of age 65 and older with income less than $40,000 may receive a freeze on their equalized assessed real property value. In Texas, school property taxes do not increase once a homeowner reaches age 65. The former is classified as an assessment value freeze and the latter is classified as a property tax freeze.

[11]See Baer (1998).

[12]See ACIR (1975).

Since state-provided property tax relief programs are extremely complicated and vary tremendously across states, I focus on three types of relief programs in this paper.[13] The first type includes homestead exemptions, homestead credits, and circuit-breakers. Relief benefits from these programs can be quantified for individual homeowners. The second and the third types refer to assessment value freezes and property tax freezes, respectively. For these two types, it is difficult to quantify their benefits for individual homeowners. Hence, I use dummy variables to indicate whether a homeowner is eligible for "assessment value freezes" or "property tax freezes."

3.2.2 Data Collection on Property Tax Relief Programs

First, I collected descriptive information from a range of publications by the U.S. Advisory Commission on Intergovernmental Relations (ACIR), the American Association of Retired Persons (AARP) and the National Conference of State Legislatures (NCSL) from 1990 to 2005. Then I compiled and organized such information by state and year. In my effort to confirm changes in these state programs over years and to resolve inconsistencies reported in various ACIR, AARP, and NCSL publications, I read state statutes that define these programs in legal terms. I searched for historical local news on property tax relief program changes. I studied program application forms, homeowners' brochures, and Q&As on state and/or local government websites. I contacted Connecticut, Delaware, Georgia, Florida, Hawaii, Illinois, Indiana, Louisiana, Maine, Maryland, Massachusetts, Mississippi, Nevada, New Jersey, North Dakota, Texas, Utah, Virginia, and Wyoming state and/or local governments for further explanation and confirmation of program details.

After obtaining accurate program descriptions, I calculated eligible benefits as a

[13] I do not consider programs that provide exactly the same amount of benefits to everyone because of the lack of within-state variation. Deferral programs are ignored because participation rates are too low. Limits that affect a jurisdiction but not necessarily individual homeowners are not considered. I also exclude local option programs that vary significantly across localities due to data collection difficulties.

function of state of residence, year, age, income, house value, Social Security income, marital status, household size, and wealth. This calculation generates three output variables: the amount of benefits from homestead exemption, homestead credit, and circuit-breaker programs that a homeowner is eligible for, whether eligible for an "assessment value freeze" program, and whether eligible for an "property tax freeze" program. Such output parameters can be calculated for any homeowner in the U.S. in any year between 1990 and 2004.

Table 3 shows year 2000 formulas used in calculating property tax relief benefits for the ten states with the most observations in my sample. The amount of eligible benefits are calculated for a hypothetical married homeowner of age 65 with an annual total household income of \$20,000, Social Security income of \$10,000, and house value of \$100,000. The amount of eligible benefits for this hypothetical homeowner varies from zero in Pennsylvania to \$1,000 in New Jersey. The formulas shown in Table 3 suggest that eligible benefits vary considerably across states, and they are sensitive to individual characteristics such as income and house value.

The first two columns in Table 4 show the percentage of homeowners eligible for relief benefits and the average benefits conditional on eligibility by age groups, income quintiles, and house value quintiles. A number of interesting patterns emerge. The percentage of homeowners eligible for relief benefits increases monotonically in age and decreases monotonically in income and housing value. Conditional on eligibility, average benefits decrease in income. Given that property taxes relief programs target low-income and elderly homeowners, such patterns are expected. The conditional average benefits increases monotonically in housing value. This pattern is likely due to the threshold design of circuit-breakers. For example, if a circuit-breaker refunds property taxes exceeding 3% of a homeowner's income, then homeowners living in more expensive houses would receive higher refunds *ceteris paribus*. The conditional average benefits do not appear to change monotonically in age. This pattern

is likely caused by complicated correlations between age and household characteristics. For example, the younger elderly homeowners tend to have higher income, which leads to lower relief benefits. The younger elderly homeowners also tend to live in more expensive houses, which leads to higher relief benefits.

The first part of Figure 2 plots conditional average benefits by state. South Dakota and Utah are missing from the map because no homeowners in the sample are from these two states. Delaware, Idaho, Maine, Montana, and Vermont each have fewer than 10 households in the sample. Because access to state identifiers is restricted, I cannot show them on this map for confidentiality reasons. This map also shows that District of Columbia, Iowa, Maryland, Michigan, Nebraska, Washington and Wisconsin have the highest average conditional benefits.

4 Empirical Strategy and Results

In this section, I present the empirical models and estimation results in studying the effect of property taxes on elderly mobility. Specifically, I first use property tax relief benefits as instruments to identify the impact of property taxes on elderly mobility. Then I use variations in housing value appreciation rates across geographic areas and years to identify such impact. I also explore whether liquidity constraints play a role in property taxes' effect on elderly homeowners' moving decisions.

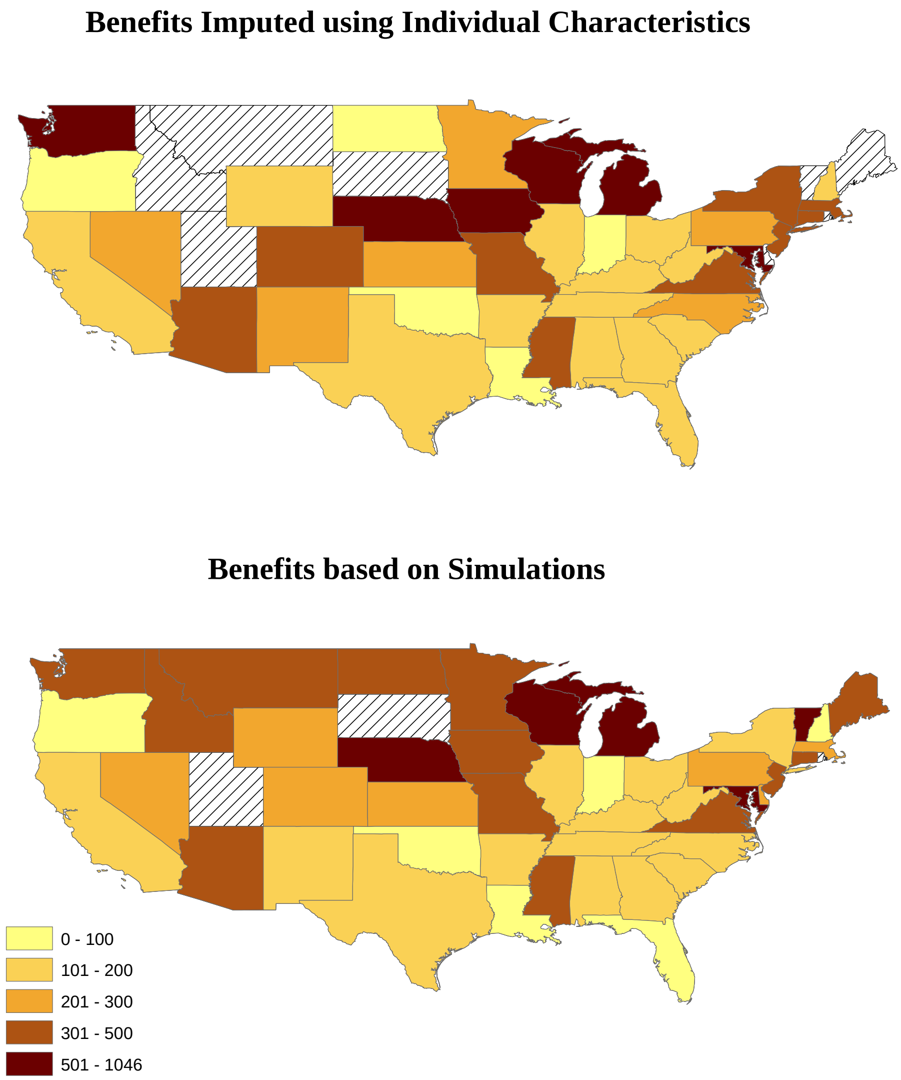

Figure 2: Conditional Average Benefits in 2000 dollars by State. Note: States shown with stripes have no or fewer than 10 households in the sample. Information for these states cannot be shown for confidentiality reasons.

4.1 Using Relief Benefits as Instruments

4.1.1 Probit and IV Probit Estimation

To investigate whether property taxes have an impact on elderly mobility, I start with the following probit model:[14]

$$\text{Prob}(Move_{ist} = 1) = \Phi(\beta_1 Tax_{ist} + \mathbf{X}_{ist}\mathbf{\Pi} + \zeta_s + \delta_t) \tag{1}$$

where $Move_{ist}$ is a binary indicator for whether household i in state s moved between time t and $t+1$, ζ_s denotes state fixed effects, δ_t denotes year fixed effects, and the covariate vector $\mathbf{X}_{ist}$ includes income quintile indicators, house value quintile indicators, financial wealth quintile indicators, gender, race, household size, number of living children, whether married, whether newly widowed, education categories (i.e. less than high school, high school graduates, some college, and college graduates), whether currently working, whether newly retired, whether spouse is currently working, whether spouse is newly retired, whether hospitalized between the last interview and the current interview,[15] age dummies, and spouse age dummies. The key variable of interest in equation (1) is Tax_{ist}, property tax payments by household i in state s at time t. If higher property taxes cause elderly homeowners to move, then we expect β_1 to be positive.

The first column in Table 5 displays estimation results of equation (1). To make the results interpretable, I show marginal effects of independent variables by calculating the marginal effect for each household and then averaging them across all households. To be

[14] I use a probit model here because the mean of the dependent variable is far from 0.5. A linear probability model (LPM) may be biased when the dependent variable is close to zero or one, and will produce predictions beyond the range of zero to one. Results shown later suggest that both probit and LPM generate similar estimation results.

[15] For the first wave in 1992, HRS asked whether the individual was hospitalized in the past year. From the second wave on, HRS asked whether the individual was hospitalized since the last interview.

consistent with results presented later in this section, standard errors shown in parenthesis are bootstrapped by 500 random draws with replacement. I implement a block-bootstrap scheme to make certain that observations are clustered at state level in estimating standard errors.[16]

The estimated effect of property taxes shown in column (1) is positive but insignificant both statistically and economically. The magnitude suggests that a \$100 increase in property taxes is associated with a mere 0.0065 percentage points increase in two-year mobility rates. It is unsurprising that the probit estimate of β_1 is small and insignificant since property taxes are likely to be endogenous to elderly homeowners' moving decisions. For instance, if there exists heterogeneity among elderly homeowners in their tastes for local public services, then homeowners who desire good local public services may choose to stay in areas that provide excellent local public services. Since such services are financed partially by property taxes, homeowners in these areas also pay high property taxes. Therefore, the unobserved tastes for local public services are correlated with both property tax payments and mobility outcomes, which causes the probit estimate of β_1 to be biased. An appropriate instrumental variable strategy has to be used to address such an endogeneity problem and to generate an consistent estimate of β_1.

Since eligibility for higher relief benefits means lower property tax payments, one potential candidate as an instrument for property taxes is eligible benefits for property tax

[16]Bertrand, Duflo and Mullainathan (2004) point out that estimated standard errors would be too small without recognizing such correlations in regression analysis. Such underestimated standard errors often lead to incorrect rejections of the null hypothesis. Two sources of correlation exist in the data studied in this paper: the correlation between observations of the same household over time and the correlation between different households in the same state. Because some households move across state borders, clustering at the state level alone may not produce consistent estimates of standard errors. Without imposing an arbitrary and restrictive structure on the variance-covariance matrix of the error term, I experimented with a multi-way clustering method suggested by Colin, Gelbach and Miller (2006). In practice, the standard errors estimated using multi-way clustering turn out to be almost identical to the standard errors estimated by clustering only at the state level. Given that implementing the multi-way clustering method in a bootstrapping framework is very computationally demanding and that the multi-way clustering method does not seem to produce any noticeable differences, I cluster standard errors only at the state level in all results presented in this paper.

relief programs. Recall that my property tax relief program Benefit Calculator imputes $Benefit_{ist}$ (i.e. the amount of eligible benefits from homestead exemptions, homestead credits, and circuit-breakers) for each household in each survey year. $Benefit_{ist}$, however, is a nonlinear function of state, age, year, household income, house value, marital status, Social Security benefits, pension benefits, household size, and total assets. To the extent that any of these factors influences elderly homeowners' moving decisions through channels other than property taxes, $Benefit_{ist}$ would correlate with both property taxes and unobserved moving tendencies, and hence, would violate the exclusion restriction. For example, homeowners who receive high Social Security benefits and pension benefits may have strong ties with local labor markets, which reduces their moving probabilities. In other words, $Benefit_{ist}$ has two sources of variation: the variation caused by relief program rules and the variation stemming from individual characteristics. The latter source of variation may be endogenous and cause probit estimates to be biased. To deal with such an endogeneity problem, I use a simulated IV approach.[17]

To simulate program generosity in state s in year t for homeowners of age a, I take the national sample of homeowners of age a who responded to HRS in year t and run them through state s's relief programs. The weighted average eligible benefits for these homeowners becomes the simulated measure of program generosity for state s in year t for homeowners of age a. Essentially, I measure state program generosity using a national representative sample that does not correlate with any individual homeowner's characteristics, but only with the exogenous variation in state, age, and year. Mathematically, $\widetilde{Benefit}_{ist}$ is constructed

[17]The idea of simulated IV can be dated back to Hausman and Wise (1976), Rosen (1976), and Hausman (1981) in labor supply studies. Currie and Gruber (1996a, 1996b) and Cutler and Gruber (1996) build on this idea and name it the "simulated IV approach". Since then, this empirical strategy has become increasingly popular among empirical studies. Hoxby and Kuziemko (2004) and Engelhardt and Kumar (2007) are recent applications of the simulated IV approach.

as follows:

$$\widetilde{Benefit}_{ist} = \frac{\sum\limits_{k \neq i} \mathbf{B}^{st}(W_{kt}, Z_{kt}) \mathbf{1}(Z_{kt} = Z_{it})}{\sum\limits_{k \neq i} \mathbf{1}(Z_{kt} = Z_{it})} \tag{2}$$

where Z_{kt} is the age of individual k at time t. W_{kt} consists of relief program eligibility determinants, some of which may be endogenous. $\mathbf{B}^{st}(\cdot)$ is the benefit formula specific to state s at time t. $\mathbf{1}(\cdot)$ is a binary function that returns one if the statement in the parentheses is true and zero otherwise. The above equation essentially takes everyone who shares the same age as individual i at time t, calculates their eligible benefits assuming that they all live in the state where individual i lives, and averages eligible benefits across all these people. To improve small sample properties, I exclude individual i when calculating $\widetilde{Benefits}_{ist}$.

$\widetilde{Benefits}_{ist}$ isolates the exogenous variation due to relief program rules from the potentially endogenous variation due to individual homeowners' socio-economic characteristics. Comparing column (2) with column (4) of Table 4 illustrates this point. Even though the conditional average benefit calculated using individual characteristics has no clear relationship with age, the simulated conditional average benefit increases monotonically in age, reflecting the fact that property tax relief programs are more generous for the oldest homeowners. In addition, column (2) shows that the conditional average benefit calculated using individual characteristics decreases monotonically in income and increases monotonically in house value. In contrast, the simulated conditional average benefit does not exhibit any relationship with either income or house value, suggesting that the simulated benefit measure $\widetilde{Benefits}_{ist}$ is rid of variations stemming from individual characteristics. In summary, the simulated benefits contain only the variation in program rules and depend exclusively on state, age, and year by construction. Even though a homeowner's unobserved tendencies to move can be correlated with factors that determine his benefit eligibility, such unobserved tendencies to move are orthogonal to relief program rules and thus, orthogonal to simulated benefits.

The second map in Figure 2 plots simulated conditional average benefits by state. South Dakota and Utah are missing from the map because no homeowners in the sample are from these two states. Comparing the two maps in Figure 2, we observe that simulated eligible benefits are highly correlated with eligible benefits calculated using individual characteristics. Nevertheless, they are noticeably different from each other. For example, the conditional average benefits based on individual characteristics are higher in Colorado than in Minnesota and North Dakota, while the simulated conditional average benefits are higher in Minnesota and North Dakota than in Colorado. $Benefit_{ist}$ is measured using residents in state s, whereas $\widetilde{Benefit}_{ist}$ is measured using a national representative sample. To the extent that residents in state s is different from the national representative sample, it is unsurprising for the two maps in Figure 2 to exhibit different patterns.

I also use two other relief benefit eligibility measures, $ValueFreeze_{ist}$ (i.e. whether eligible for an assessment value freeze program) and $TaxFreeze_{ist}$ (i.e. whether eligible for a property tax freeze program) to instrument for property tax payments. Because eligibilities for assessment value freeze programs and property tax freeze programs depend only on state, age, year, and household income, and because state, age, year, and household income are arguably exogenous covariates, $ValueFreeze_{ist}$ and $TaxFreeze_{ist}$ satisfy the exclusion restriction and may be used as valid instruments for property tax payments.[18]

To implement the simulated IV strategy in a probit framework, I use the two-step estimator suggested by Rivers and Vuong (1988).[19] Beside computational ease, the Rivers-Vuong two-step IV approach has another appealing feature. The usual probit t-test on $\hat{v}$, which is a consistent estimate of the first-stage error term, is a valid test of the null hy-

[18] I also tried simulating $ValueFreeze_{ist}$ and $TaxFreeze_{ist}$ and using the simulated eligibility measures as instruments for property taxes. The estimation results remain the same.

[19] The Rivers-Vuong two-step approach is a limited information procedure. Thus, it is less efficient than the conditional maximum likelihood estimation (MLE). In practice, I find MLE computationally difficult, and iterations do not converge.

pothesis that Tax_{ist} is exogenous. Such a test is equivalent to the Hausman specification test suggested by Hausman (1978). Because I use a two-step procedure to estimate the IV probit model, standard errors need to be adjusted accordingly. I choose to obtain consistent estimates of standard errors by bootstrapping in lieu of the delta-method for two reasons. First, bootstrapping is computationally easier to implement. Second, bootstrapping provides higher-order refinements while the delta-method is only a first-order approximation (Horowitz (2001)).

Column (2) of Table 5 shows the IV probit estimation results. The estimated marginal effect of property taxes is both statistically and economically significant. The point estimate suggests that a \$100 increase in annual property tax payments induces the two-year mobility rate to increase by 0.76 percentage points. Given that the baseline two-year mobility rate among elderly homeowners is 9%, the IV probit estimate implies that a \$100 increase in annual property taxes induces mobility to rise by 8 percent. Moreover, the coefficient on $\hat{v}$ is statistically different from zero at 0.01 level, rejecting the null hypothesis that Tax_{ist} is exogenous and confirming the necessity of an IV strategy.

Table 5 also shows that the instruments used here - $\widetilde{Benefits}_{ist}$, $ValueFreeze_{ist}$, and $TaxFreeze$ - are quite strong in the first-stage regression. The first-stage F-stat is 43 and the concentration parameter is 126. Stock, Wright and Yogo (2002) suggest that the rule of thumb for detecting weak instruments is to check whether the first-stage F-stat exceeds 10. Hansen, Hausman and Newey (2006) conclude that a concentration parameter of 30 or above suggests that there is no weak instruments problem. By either standard, $\widetilde{Benefits}_{ist}$, $ValueFreeze_{ist}$, and $TaxFreeze$ are strong instruments for Tax_{ist}.

The estimated marginal effects of other covariates are mostly consistent with our expectation and the previous literature's findings. For instance, homeowners who are currently working are less likely to move. Homeowners who are recently widowed have higher moving

probabilities. Large families are less prone to move, supposedly due to high moving costs. Negative health shocks and number of living children are associated with higher mobility rates, which echoes the finding by Silverstein and Angelelli (1998) that older parents engage in return migration in order to live closer to children from whom they receive care.

4.1.2 Allowing for Household Heterogeneity - Random Effects Probit Model

An advantage of using panel data is that we can take into account unobserved individual heterogeneity. To simplify notations, I denote y_{it} as the mobility outcome, $\mathbf{x}_{it}$ as a vector of all explanatory variables, and c_i as the time-constant unobserved household effects. The probit model assumes

$$P(y_{it} = 1|\mathbf{x}_{it}, c_i) = \Phi(\mathbf{x}_{it}\theta + c_i), \qquad t = 1, ..., T$$

The density of $(y_{i1}, ..., y_{iT})$ can be written as

$$\begin{aligned} f(y_{i1}, ..., y_{iT}|\mathbf{x}_i, c_i; \theta) &= \prod_{t=1}^{T} f(y_{it}|\mathbf{x}_{it}, c_i; \theta) \\ &= \prod_{t=1}^{T} \Phi(\mathbf{x}_{it}\theta + c_i)^{y_{it}}[1 - \Phi(\mathbf{x}_{it}\theta + c_i)]^{1-y_{it}} \end{aligned}$$

Ideally, we would prefer estimating a fixed effects probit model where no assumption is made about the distribution of c_i, and c_i are estimated as parameters along with θ. Unfortunately, the data used in this paper have a small T and a large N. The fixed effects probit model fails to produce a consistent estimate of θ due to the incidental parameters problem. Nevertheless, if we are willing to assume the conditional distribution of c_i, we can still estimate a random effects probit model.

The traditional random effects probit model imposes the assumption that c_i are

normally distributed conditional on $\mathbf{x}_i$:

$$c_i|\mathbf{x}_i \sim \text{Normal}(0, \sigma_c^2)$$

Because $\{c_i\}$ are unobserved, they cannot appear in the likelihood function explicitly. Instead, we find the joint distribution of $(y_{i1}, ..., y_{iT})$ by integrating out c_i. Under the conditional normality assumption of c_i,

$$\begin{aligned} f(y_{i1}, ..., y_{iT}|\mathbf{x}_i; \theta, \sigma_c) &= \int_{-\infty}^{\infty} \left[\prod_{t=1}^{T} f(y_{it}|\mathbf{x}_{it}, c_i, \theta) \right] \frac{1}{\sigma_c} \phi \left(\frac{c}{\sigma_c} \right) dc \\ &= \int_{-\infty}^{\infty} \left[\prod_{t=1}^{T} \Phi(\mathbf{x}_{it}\theta + c_i)^{y_{it}} [1 - \Phi(\mathbf{x}_{it}\theta + c_i)]^{1-y_{it}} \right] \frac{1}{\sigma_c} \phi \left(\frac{c}{\sigma_c} \right) dc \end{aligned}$$

The log-likelihood function for the entire sample of N households can be maximized with respect to θ and σ_c.

Columns (3) and (4) in Table 6 present the estimation results of the random effects probit model and that of the two-step IV random effects probit model. The marginal effects are very close to those estimated by the probit and IV probit models. The point estimate of the IV random effects probit model suggests that a \$100 increase in annual property tax payments causes the two-year mobility rate to go up by 0.73 percentage points. The estimated coefficient on $\hat{v}$ is statistically different from zero at 0.01 level, suggesting that Tax_{ist} is endogenous to mobility outcomes. As a robustness check, OLS and 2SLS estimation results are shown in columns (5) and (6). The LPM also generates similar results.

4.1.3 Robustness Checks across Sub-samples and Specifications

In this section, I estimate the effect of property taxes on elderly mobility using different sub-samples and different model specifications. The purpose of this exercise is to check whether

my findings are driven by some peculiar sub-population and whether the estimated results are robust to various regression specifications. I first exclude the AHEAD cohort. The AHEAD cohort were born before 1924 and are the oldest cohort in the sample. Even though I have included in the main specification a full set of age dummies and year dummies, which effectively controls for cohort fixed effects, coefficients on all covariates have been restricted to be the same across cohorts. If the oldest elderly move for reasons completely different from those of the younger elderly, they may respond to property taxes and relief programs distinctively from other cohorts. The regression results excluding the AHEAD cohort are shown in columns (3) and (4) of panel A in Table 7. The IV probit point estimate is similar to the one obtained when the AHEAD cohort is included.

Next, I drop households living in California because Proposition 13 creates a very unusual institutional setting. Proposition 13 in California was adopted in 1978. It limits property tax rate at 1% and requires assessment values grow no more than 2% per year unless the house is sold and re-assessment is carried out. Wasi and White (2005) find that Proposition 13 has a lock-in effect on homeowners in California. In the late 1980s, two amendments to Proposition 13 were passed. They allow any homeowner of age 55 or above who move to another house of equal or less market value within the same county to pay property taxes on the previous house' assessment value. Ferreira (2005) use a regression discontinuity strategy to show that mobility rates of 55-year-old homeowners are 25% higher than those of 54-year-old homeowners in California after those amendments were enacted. Proposition 13 may cause elderly homeowners in California to respond differently to property taxes and relief programs than elderly homeowners in other states. The regression results without California observations are shown in columns (5) and (6) of panel A in Table 7. They appear to be very similar to the results obtained for the entire sample.

I then investigate whether the results I find are driven by a small fraction of house-

holds who made multiple moves during the sample period. Specifically, I drop households who moved three or more times between 1992 and 2004.[20] Columns (7) and (8) of panel A in Table 7 present the probit and IV probit estimation results. The reported marginal effects remain unchanged, suggesting that the estimated marginal effect of property taxes on elderly mobility is not driven by frequent movers.

By construction, the variation in the simulated benefits comes from state, age, and year. To ascertain that the results I have found in my main regressions do not originate from uncontrolled two-way interactions between state, age and year, I add two-way interaction fixed effects in the property tax regression. The first two columns of panel B in Table 7 display the original estimation results without controlling for any two-way interactions. In columns (3) and (4), I add controls for state×year fixed effects. In columns (5) and (6), I add controls for year×age fixed effects. In columns (7) and (8), I add controls for state×age fixed effects.

In the case of adding state×age fixed effects, around 1,500 additional fixed effects are controlled for in the regression model. Not surprisingly, estimated standard error becomes considerably larger and the marginal effect is significant only at 0.10 level. Nevertheless, the estimated coefficient on property tax payments always remains positive and of roughly the same magnitude.

In summary, estimation results from the probit model, the random effects probit model, and the LPM all suggest that property taxes play an important role in elderly homeowners' moving decisions. The results do not appear to be driven by some peculiar subsample and are robust to adding two-way interaction fixed effects. These estimation results also demonstrate that it is essential to recognize that property taxes are endogenous to the

[20] I am aware that this procedure selects the sample based on the dependent variable. The sole purpose of this exercise is to check whether the estimated marginal effect of property taxes on elderly mobility changes significantly once we exclude frequent movers.

probability of moving. The central IV estimate suggests that a \$100 increase in property taxes induces the two-year mobility rate to rise by 0.76 percentage points, representing a 8% increase from the baseline average two-year mobility rate of 9 percent. Such a large estimated impact of property taxes may be a manifestation of the local average treatment effects (LATE) formulated by Imbens and Angrist (1994). The instruments used to identify the causal effect of property taxes - simulated benefits, eligibility for assessment value freeze program, and eligibility for property tax freeze program - affect property taxes only of homeowners who both are eligible for and actually take up property tax relief. Because property tax relief programs are designed to assist low-income and elderly homeowners, and because people who actually take up these programs tend to be more sensitive to property taxes, it is not surprising that the IV estimates are large in magnitude. The estimates shown here measure the mobility response to property taxes among the compliers (i.e. eligible homeowners who actually receive benefits from property tax relief programs), so one must be cautious when generalizing these results to the overall population.

4.2 Using Variations in Housing Appreciation Rates

In the previous section, I used eligible benefits for property tax relief programs as instruments and find that higher property taxes induce elderly homeowners to move. To the extent that these instruments affect property tax payments only of homeowners who are both eligible for and actually enroll in property tax relief programs, the effect found may be specific to such homeowners. In this section, I use a different empirical strategy to identify the effect of property taxes on mobility rates of all elderly homeowners. Specifically, I make use of the intuition that homeowners living in places with high Effective Tax Rates (i.e. the property tax payment to house value ratio) and high housing appreciation rates will be the most affected by rising property taxes. If increasing property taxes induce elderly homeowners to

move, individuals subject to high $ETR_{ist} \times h_{mt}$ are more likely to move than those subject to low $ETR_{ist} \times h_{mt}$, where h_{mt} is the housing appreciation rate for Metropolitan Statistical Area (MSA) m at time t.[21] In particular, I estimate the following probit model:

$$\text{Prob}(Move_{ist} = 1) = \Phi(\gamma_1 ETR_{ist} \times h_{mt} + \gamma_2 ETR_{ist} + \gamma_3 h_{mt} + \mathbf{X}_{ist}\mathbf{\Pi} + \alpha_s + \delta_t) \quad (3)$$

If property taxes are important in elderly homeowners' moving decisions, then we would expect γ_1 to be positive. The identification assumption underlying this difference-in-differences framework is that, in the absence of a property tax effect, increases in housing prices have the same effect on low-ETR areas as on high-ETR areas. This assumption is very strong because it assumes that ETR varies across places for reasons exogenous to individual homeowners. It precludes situations where increases in property tax revenues are driven purely by homeowners' demand for more and better local services.

Note that individual level variables ETR_{ist} may be endogenous for the same reasons that property tax payments may be endogenous. Hence, estimates of equation (3) are inconsistent without an appropriate instrumental variable strategy. I use state-year level median effective tax rates ETR_{st}, and the interaction between ETR_{st} and h_{mt} to instrument for their individual level counterparts.[22] The regression outcomes are reported in columns (1) and (2) of Table 8.

The results in Table 8 show a number of interesting patterns. The estimated

[21]For homeowners who do not live in MSAs, I use state-level housing appreciation rates instead. About 75% of the sample live in MSAs.

[22]The housing appreciation rates h_{mt} are from the Office of Federal Housing Enterprise Oversight (OFHEO). OFHEO publishes quarterly House Price Indexes (HPI) by state and by MSA. I adjust HPI for inflation using CPI to obtain real housing appreciation rates h_{mt}. The data I used to construct state-level median effective tax rates ETR_{st} are from two sources. The first is the 2000 Census, which provides median effective tax rate by state. The second is the "Residential Property Tax Rates in the Largest City in Each State" published in the census Statistical Abstract series. Assuming the time trend of ETR in these largest cities coincides with the time trend of median ETR in states, I use the 2000 Census data as a baseline and construct the state-year specific ETR_{st}.

marginal effect of $ETR_{ist} \times h_{mt}$ in the IV probit model is positive and statistically significant, suggesting that higher property taxes induces elderly homeowners to relocate.[23] The estimated marginal effect of h_{mt} is negative and marginally significant. The variable h_{mt} measures how much housing values have changed from last year to this year. If homeowners extrapolate housing price movements, they would expect housing value to continue increasing in a housing market boom and to continue declining in a housing market bust. γ_3 being negative implies that in times when housing prices keep rising, homeowners decide to delay moving and cash in the expected capital gains later. The Hausman test appears to reject the exogeneity assumption and suggests that an instrumental variable approach is necessary for consistent estimates. In addition, the LPM generates very similar results.

I interpret the estimated marginal effects using the following example: Take ETR_{ist} to be 0.01 and h_{mt} to be 5% as the benchmark scenario. These numbers are chosen because they are close to the sample medians. Consider an increase in annual housing appreciation rate from 5% to 10%. The direct housing appreciation effect, $\gamma_3 h_{mt}$, implies a decrease in the two-year mobility rate by 1.3 ($= -0.262 \times 0.05$) percentage points. The indirect property-tax-increase effect, $\gamma_1 ETR_{ist} \times h_{mt}$, suggests a rise in the mobility rate by 1.2 ($= 0.235 \times 0.05 \times 0.01 \times 100$) percentage points. Therefore, the net effect of an increase in the housing appreciation rate from 5% to 10% is a decrease of 0.1 ($= -1.3 - 1.2$) percentage points in the two-year mobility rate. Now take ETR_{ist} to be 0.02 and consider the same increase in h_{mt} from 5% to 10%. The direct housing appreciation effect is still a 1.3 percentage point decrease in the two-year mobility rate. The indirect property-tax-increase effect, however, will increase mobility by 2.4 ($= 0.235 \times 0.05 \times 0.02 \times 100$) percentage points. Therefore, the net effect is a 1.1 ($= -1.3 + 2.4$) percentage point increase in the two-year mobility rate.

[23] I multiplied the ETR_{ist} and ETR_{st} by 100 to obtain easy-to-read estimated coefficients.

The IV probit estimation results suggest that homeowners living in places with both high effective property tax rates and rapid housing value appreciation are the most affected by rising property taxes. Exploiting variations in housing value appreciation rates rather than in state-provided property tax relief programs, the results shown in this section complement and reinforce the previous finding that property taxes play an important role in elderly homeowners' moving decisions. Furthermore, finding a large and statistically significant effect of $ETR_{ist} \times h_{mt}$ on elderly mobility suggests that increasing demand for local public services cannot fully explain the sharp increases in property taxes during the recent years, at least not for elderly homeowners. If property tax increases are entirely driven by elderly homeowners' demand for more and better local public services, then we would not expect elderly mobility to rise in areas with high ETR and fast housing price appreciation.

4.3 Do Liquidity Constraints Matter?

There are two potential explanations for why elderly homeowners move when property taxes increase. The first focuses on liquidity constraints. Under the assumption that elderly homeowners have substantial emotional and psychological attachment to their homes, they do not wish to move unless they become liquidity-constrained and have to trade down. This explanation implies that elderly homeowners do not perceive their housing wealth in the same way they perceive their financial wealth. It also suggests that providing property tax relief programs may be welfare-improving for elderly homeowners with difficulties accessing the credit market and cashing out their housing wealth.

The second explanation is a demand adjustment story. When homeowners were in their prime-age living with school-aged children, they were willing to pay high property taxes and receive local services including public schools. As homeowners grow older, they no longer have school-age children and, consequently, they do not value school services as

much. When property taxes increase, elderly homeowners may decide to relocate to places with lower property taxes and fewer, or different public services. This explanation suggests that property tax relief programs may have distorted elderly homeowners' mobility decisions and locked in people who optimally should have moved.

The liquidity constraint explanation and demand adjustment explanation have distinct policy implications. Pioneered by Zeldes (1989), a sizable literature shows both theoretically and empirically that liquidity constraints may have a significant impact on household consumption and saving trajectories. If there exist impediments in the credit market that prevent elderly homeowners from borrowing against their housing wealth, providing property tax relief to them may help to smooth consumption and to enhance welfare. On the other hand, if moving from a place with high property taxes to a place with low property taxes gives elderly homeowners higher utility, then property tax relief may artificially lock elderly homeowners into their long-time home. To explore whether liquidity constraints explain the effect of property taxes on elderly mobility, I estimate

$$\begin{aligned} \text{Prob}(Move_{ist}) &= \Phi(\eta_1 Tax_{ist} \times LC_{ist} + \eta_2 Tax_{ist} \times (1 - LC_{ist}) \\ &+ \mathbf{X}_{ist}\mathbf{\Pi} + \zeta_s + \delta_t) \end{aligned} \tag{4}$$

where LC_{ist} is a binary variable indicating whether household i faces liquidity constraints at time t. In practice, I define LC_{ist} in three different ways: $LC_{ist} = 1$ if in the bottom two income quintiles, $LC_{ist} = 1$ if in the bottom two financial wealth quintiles, and $LC_{ist} = 1$ if in the bottom two education categories (i.e. less than high school and high school graduates). If liquidity constraints are indeed the reason why higher property taxes induce elderly homeowners to move, then we would expect that individuals facing liquidity constraints are more affected by property taxes than those not facing liquidity constraints. In other words, we would expect $\eta_1 > \eta_2$.

Using eligible benefits for property tax relief programs as instruments for $Tax_{ist} \times LC_{ist}$ and $Tax_{ist} \times (1 - LC_{ist})$, I find mixed evidence on whether liquidity constraints may have played a role in property taxes' impact on elderly homeowners' moving decisions. The estimates of η_1 are larger than that of η_2 regardless of whether being liquidity-constrained is defined by income, financial wealth, or education. For example, for households in the bottom two income quintiles, the IV-probit estimates suggest that a \$100 increase in property taxes induces the two-year mobility rate to increase by 0.92 percentage points. In contrast, it induces the two-year mobility rate to increase by only 0.58 percentage points for households in the top three income quintiles. Unfortunately, standard errors of the estimated marginal effects are large and the null hypothesis that $\eta_1 = \eta_2$ cannot be rejected.

5 Conclusion

Property taxes are the most important tax revenue source for local governments. The recent housing market boom led to significant increases in homeowners' property tax liabilities. Both policy-makers and the general public are concerned by the prospect that house-rich but income-poor elderly homeowners are overburdened by rising property taxes. The goal of this paper is to provide empirical evidence on whether property taxes play an important role in elderly homeowners' moving decisions.

Using instrumental variable approaches, this paper finds that property taxes are important in elderly homeowners' moving decisions. The central point estimates suggest that a \$100 increase in annual property taxes leads to a 0.76 percentage point increase on average in two-year mobility rates. The median annual property tax payment in my sample is \$1200, and the average two-year mobility rate of elderly homeowners is 9 percent. My point estimates suggest that the impact of property taxes on elderly mobility is economically

significant. In addition, the effect of property taxes is most pronounced for homeowners living in areas that rely heavily on property taxes and that experience remarkable housing value appreciation. A variety of robustness checks are performed to test the stability of the found effects.

According to the 2004 data, property tax relief programs cost about $10 billion a year in the United States.[24] In some states, these relief programs are provided at a great expense of lost revenues. For example, circuit-breakers in Vermont cost about 10% of total property tax revenues every year. Is the money well spent? Does the benefit of having these programs justify their cost? If the effect of property taxes on mobility is driven by demand adjustment, property tax relief programs would keep elderly homeowners from relocating to places where the marginal price of local services matches the marginal benefit. Thus, we essentially spend valuable resources locking homeowners in their houses and preventing them from following an optimal housing consumption path. In contrast, if the effect is due to liquidity constraints, providing generous property tax relief programs may alleviate such constraints and allow people who value the house the most to stay in it. This paper offers mixed evidence on whether liquidity constraints serve as a driving force behind the effect of increasing property taxes on elderly mobility. More empirical studies are needed before we can fully assess the welfare implication of property tax relief programs.

Many intriguing and important questions remain unexplored with regard to the impact of property taxes on elderly homeowners. At present, little empirical analysis has been conducted to address the question why effective tax rates did not decline in proportion to the increases in housing prices. Dye and Reschovsky (2007) suggests that cuts in state school aid caused by state fiscal crisis may be partially responsible for rising property taxes in recent years. Furthermore, virtually no evidence has been presented to rationalize the prevalence

[24] Author's estimate using 2004 circuit-breaker cost data reported in Lyons et al (2007).

of property tax relief programs and the political popularity associated with expanding these programs. Do elderly homeowners enjoy more political power by voting more often than non-elderly homeowners? Do state and local governments use property tax relief programs to entice retiree migrants? Do population aging and baby-boomers' entering retirement age imply diminishing support for public-school spending? Poterba (1998) discusses issues related to demographic change and the political economy of public education. More research is called for to address such questions.

The second set of research questions includes investigating the best way of providing property tax relief. Economists believe that reverse mortgages are an efficient mechanism for elderly homeowners to tap into their housing wealth and to achieve consumption smoothing toward the end of their life-cycle. The fact that very few eligible elderly homeowners take up property tax deferral programs is consistent with the observation that the reverse mortgage market in the U.S. is tiny. Studying why property tax deferral programs are unpopular among elderly homeowners could help us better understand whether elderly homeowners perceive their housing wealth in the same way they perceive their financial wealth, and whether the absence of a thriving reverse mortgage market is due to a lack of demand. The third set of questions extends beyond mobility and asks whether property taxes induce other behavior responses among elderly homeowners. These remaining questions are left for future study.

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Table 1: Mobility and Homeownership of HRS Households

A. Fraction of Homeowners Moving between Adjacent Waves

Wave	Mean	SE	No. Obs.
1992-1994	0.063	0.004	3641
1994-1996	0.082	0.005	2764
1996-1998	0.075	0.005	3264
1998-2000	0.092	0.005	3084
2000-2002	0.133	0.006	2851
2002-2004	0.119	0.006	2643

B. Tenure Distribution

Wave	Homeowner	Renter	Other	No. Obs.
1992	0.771	0.194	0.035	6726
1994	0.788	0.180	0.031	5999
1996	0.800	0.177	0.024	5712
1998	0.804	0.164	0.032	5432
2000	0.809	0.157	0.034	5071
2002	0.817	0.148	0.035	4826
2004	0.807	0.147	0.046	4645

C. Tenure Transition Matrix

	To Own(%)	To Rent(%)	To Other(%)	No. Obs.
From Own	80.66	14.37	4.97	1909
From Rent	21.98	70.68	7.34	1266
From Other	22.87	44.58	32.54	206

Note: This table refers to HRS cohort (born between 1931 and 1941) households only. Household weights are used.

Table 2: Summary Statistics of Key Variables

	Mean	Median	SD
Moved between Waves	0.09		0.29
Fraction of Cross-State Moves	0.17		0.38
Property Tax	1,756	1,200	2,693
House Value	149,811	110,849	179,146
Income	63,776	41,900	102,144
Financial Wealth	126,526	26,000	528,838
Having Mortgage or Home Loan	0.46		0.50
Age	64.5		9.8
Male	0.52		0.50
White	0.91		0.29
Household Size	2.25		1.15
Number of Children	3.06		1.93
Less than High School	0.22		0.41
High School Graduates	0.32		0.47
Some College	0.22		0.42
College Graduates	0.24		0.43
Currently Working	0.43		0.49
Currently Retired	0.48		0.50
Currently Disabled	0.02		0.13
Newly Retired	0.08		0.28
Married	0.66		0.47
Separated or Divorced	0.12		0.32
Widowed	0.20		0.40
Newly Widowed	0.02		0.14
Recently Hospitalized	0.30		0.46

Note: $N = 29,213$. The sample is restricted to households who were homeowners in the current wave and who have valid data for all variables. Property tax, income, house value, and financial wealth are in 2000 dollars. Household weights are used.

Table 3: Property Tax Relief Benefit Formula Examples

State	**Formula Used For a Hypothetical Homeowner** (year=2000, age=65, married, Income=\$20,000, SSB=\$10,000, HV=\$100,000)	**Benefit**
FL	$0.5 \times ETR_{FL} \times \min(HV, 25000)$	\$146
CA	$0.01 \times \min(34000, HV) \times 0.96 \times \frac{34877 - \max(Income, 8719)}{34877 - 8719}$	\$186
MI	$\min(1200, \max(0, ETR_{MI} \times HV - 0.035 \times Income))$	\$536
TX	$0.7 \times ETR_{TX} \times \min(HV - \min(HV, 15000), 10000)$	\$119
NY	$0.5 \times ETR_{NY} \times \min(HV - \min(HV, 10000), 40000)$	\$367
IL	$ETR_{IL} \times \min(HV, 6000)$ $+ \min\left(700 - 630 \times \frac{\min(Income, 14000)}{14000}, \max(0, ETR_{IL} \times HV - 0.035 \times Income)\right)$	\$166
PA	$\min\left(ETR_{PA} \times HV, 500 \times \left(1 - \frac{\max(Income - 0.5 \times SSB, 5500) - 5500}{15000 - 5500}\right)\right)$	\$0
NJ	$250 \times (Income - SSB \leq 10000)$ $+ \max(150, \min(750, ETR_{NJ} \times HV - 0.05 \times Income))$	\$1000
GA	$0.5 \times ETR_{GA} \times \min(HV, 10000) + 0.5 \times ETR_{GA} \times \min(HV, 25000)$	\$150
MN	$\min\left(510, 0.5 \times \max\left(0, ETR_{MN} \times HV - \left(0.01 + 0.03 \times \frac{Income}{71700}\right) \times Income\right)\right)$	\$510

Note: ETR is the state-year specific average effective property tax rate. HV is house value. SSB is Social Security benefit. Benefits shown here refer to eligible benefits from state-provided homestead exemptions, homestead credits, and circuit-breakers.

Table 4: Property Tax Relief Program Benefits

	Eligible Benefits		Simulated Benefits	
	Percentage Eligible (1)	Conditional Avg Benefit (2)	Percentage Eligible (3)	Conditional Avg Benefit (4)
	A. By Age Groups			
age<55	5%	363	6%	248
55-59	6%	382	7%	262
60-64	13%	332	14%	274
65-74	45%	313	45%	305
≥75	53%	350	53%	319
	B. By Income Quintiles			
Lowest	55%	359	34%	275
2nd Quintile	33%	338	31%	294
3rd Quintile	18%	330	26%	287
4th Quintile	11%	300	20%	283
Highest	5%	158	16%	281
	C. By House Value Quintiles			
Lowest	34%	187	29%	253
2nd Quintile	25%	272	25%	272
3rd Quintile	23%	380	25%	230
4th Quintile	22%	427	24%	302
Highest	15%	458	23%	285

Note: All dollar amounts are in 2000 dollars. Eligible benefits are calculated based on individual homeowners' characteristics. Simulated benefits are calculated by simulation for each state-age-year cell. "Percentage Eligible" is the percentage of homeowners who are eligible for homestead exemptions, homestead credits, or circuit-breakers. "Conditional Avg Benefit" is the average benefit from homestead exemptions, homestead credits, and circuit-breakers conditional on being eligible for these programs. Household weights are used.

Table 5: Effect of Property Taxes on Mobility - Probit Model

	Probit	**IV Probit**
	(1)	(2)
Property Taxes (in 10,000)	0.0065	0.7624***
	(0.0115)	(0.2692)
Male	0.0021	-0.0010
	(0.0060)	(0.0067)
White	0.0458***	0.0385***
	(0.0086)	(0.0101)
Household Size	-0.0105***	-0.0104***
	(0.0026)	(0.0028)
Number of Children	0.0070***	0.0070***
	(0.0013)	(0.0014)
Married	-0.0363	-0.0413
	(0.0370)	(0.0394)
Newly Widowed	0.0391***	0.0453***
	(0.0131)	(0.0140)
Currently Working	-0.0186***	-0.0264***
	(0.0064)	(0.0076)
Newly Retired	0.0236***	0.0129
	(0.0076)	(0.0114)
Spouse Currently Working	-0.0196**	-0.0188*
	(0.0077)	(0.0101)
Spouse Newly Retired	-0.0013	0.0052
	(0.0098)	(0.0109)
Recently Hospitalized	0.0108**	0.0096
	(0.0051)	(0.0060)
Hausman Test		-4.1179***
(Coef on first-stage residual $\hat{v}$)		(1.3602)
First Stage F-Stat		43
Concentration Parameter		126

Note: This table reports marginal effects derived from estimates of equation (1). $N = 22,250$. In addition to the variables shown in the table, the regressions also include income quintile dummies, house value quintile dummies, financial wealth quintile dummies, age dummies, spouse age dummies, states fixed effects and year fixed effects. The simulated benefit measure $\widetilde{Benefit}_{ist}$ and binary variables $ValueFreeze_{ist}$ and $TaxFreeze_{ist}$ are used as instruments in the IV specification. Marginal effects shown are weighted averages across the population. Standard errors are bootstrapped by 500 random draws with replacement clustered at state level. Household weights are used. ***, **, * denote significance at the 1%, 5%, and 10% levels respectively.

Table 6: Effect of Property Taxes on Mobility - Probit, Random Effect Probit, and LPM

	Probit		**RE Probit**		**LPM**	
		IV		IV		IV
	(1)	(2)	(3)	(4)	(5)	(6)
Property Taxes	0.0065	0.7624***	0.0046	0.7260**	0.0068	0.6058**
(in 10,000)	(0.0115)	(0.2692)	(0.0054)	(0.2901)	(0.0095)	(0.2398)
Hausman Test		-4.0079***		-4.9617***		
(Coef on first-stage residual $\hat{v}$)		(1.3602)		(1.7912)		

Note: $N = 22,250$. In addition to the variables shown in the table, the regressions also include income quintile dummies, house value quintile dummies, financial wealth quintile dummies, male, white, household size, number of children, whether married, whether newly widowed, education categories, whether currently working, whether newly retired, whether spouse is currently working, whether spouse is newly retired, whether hospitalized, age dummies, spouse age dummies, state fixed effects, and year fixed effects. The simulated benefit measure $\widetilde{Benefit}_{ist}$ and binary variables $ValueFreeze_{ist}$ and $TaxFreeze_{ist}$ are used as instruments in the IV specifications. Marginal effects shown are weighted averages across the population. Standard errors in column (1)-(4) are bootstrapped with 500 random draws with replacement clustered at state level. Standard errors in column (5) and (6) are clustered at state level. Household weights are used. ***, **, * denote significance at the 1%, 5%, and 10% levels respectively.

Table 7: Effect of Property Taxes on Mobility - Robustness Checks

A. Various Sub-Samples

	Orig. Sample		Drop AHEAD		Drop CA		Drop Freq. Movers	
		IV		IV		IV		IV
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Property Taxes	0.0065	0.7624***	0.0039	0.7565**	0.0010	0.7697***	0.0084	0.7676***
(in 10,000)	(0.0115)	(0.2692)	(0.0124)	(0.3172)	(0.0114)	(0.2590)	(0.0098)	(0.2670)
N	22,520	22,520	17,082	17,082	19,963	19,963	21,691	21,691

B. Add Two-Way Interaction Fixed Effects

	Orig. Specification		Add State*Year		Add Year*Age		Add State*Age	
		IV		IV		IV		IV
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Property Taxes	0.0065	0.7624***	0.0054	0.5242**	0.0057	0.7726***	0.0091	0.8716*
(in 10,000)	(0.0115)	(0.2692)	(0.0117)	(0.2649)	(0.0120)	(0.2555)	(0.0206)	(0.4570)
N	22,520	22,520	22,520	22,520	22,520	22,520	22,520	22,520

Note: This table reports the robustness checks of equation (1). In addition to the variables shown in the table, the regressions also include income quintile dummies, house value quintile dummies, financial wealth quintile dummies, male, white, household size, number of children, whether married, whether newly widowed, education categories, whether currently working, whether newly retired, whether spouse is currently working, whether spouse is newly retired, whether hospitalized, age dummies, spouse age dummies, state fixed effects, and year fixed effects. The simulated benefit measure $\widetilde{Benefit}_{ist}$ and binary variables $ValueFreeze_{ist}$ and $TaxFreeze_{ist}$ are used as instruments in the IV specification. Marginal effects shown are weighted averages across the population. Standard errors are bootstrapped by 500 random draws with replacement clustered at state level. Household weights are used. ***, **, * denote significance at the 1%, 5%, and 10% levels respectively.

Table 8: Interaction between ETR and House Price Appreciation Rates

	Probit (1)	IV Probit (2)	OLS (3)	2SLS (4)
$ETR_{ist} \times h_{mt}$	0.031	0.235**	0.026	0.234**
	0.053	(0.107)	(0.082)	(0.093)
ETR_{ist}	0.181	2.81	0.169	2.93
	(0.303)	(2.70)	(0.276)	(2.90)
h_{mt}	-0.042	-0.262*	-0.036	-0.260**
	(0.087)	(0.137)	(0.142)	(0.102)
Hausman Test				
(Coef on first-stage residual $\hat{v}_1$)		-1.67***		
		(0.52)		
(Coef on first-stage residual $\hat{v}_2$)		-15.5		
		(19.0)		
N	29,102	29,102	29,102	29,102

Note: This table reports marginal effects derived from estimates of equation 3. In addition to the variables shown in the table, the regressions also include income quintile dummies, house value quintile dummies, financial wealth quintile dummies, male, white, household size, number of children, whether married, whether newly widowed, education categories, whether currently working, whether newly retired, whether spouse is currently working, whether spouse is newly retired, whether hospitalized,age dummies, spouse age dummies, states fixed effects and year fixed effects. h_{mt} is MSA level housing value appreciation rates. State effective tax rate ETR_{st} and the interaction between ETR_{st} and h_{mt} are used as instruments for ETR_{ist} and $ETR_{ist} \times h_{mt}$ in the IV specifications. Marginal effects shown are weighted averages across the population. Standard errors in column (1) and (2) are bootstrapped by 500 random draws with replacement clustered at state level. Standard errors in column (3) and (4) are clustered at state level. Household weights are used. ***, **, * denote significance at the 1%, 5%, and 10% levels respectively.

ing tax exemption for lands granted to said college for the benefit of education where rents from such property are used for "the benefit of education." State ex rel. Bannister v. Trustees of William Jewell College, 364 Mo. 199, 260 S.W.(2d) 479.
(1954) Section 353.110 is authorized by section 7, Article X of the Constitution and does not conflict with section 6, Article X. Land Clearance for Redevelopment Auth. v. City of St. Louis (Mo.), 270 S.W.(2d) 58.
(1957) Buildings on land owned by the United States, erected by private corporations under lease with government held subject to taxation in this state. Such buildings were properly assessed as real estate. State ex rel. Benson v. Personnel Housing, Inc. (Mo.), 300 S.W.(2d) 506.
(1964) Hospital owned and operated by association, facilities of which generally were available only to members who paid monthly dues to the association, was not exempt from taxation though operated at a loss, since not operated exclusively for purposes purely charitable. Frisco Employees' Hospital Ass'n. v. State Tax Com'n. (Mo.), 381 S.W.(2d) 772.
(1966) Residential properties owned by charitable hospital and occupied by key personnel necessary to efficient operation who were on call 24 hours a day were used exclusively for charitable purposes and hence exempt from taxation. Bethesda General Hospital v. State Tax Commission (Mo.), 396 S.W.(2d) 631.
(1968) Leasehold interest held by private corporation in real estate owned by municipality is within definition of "real property" of section 137.010 RSMo, and is taxable as real property and the exemption accorded the municipality from taxation on its real estate does not extend to a privately owned leasehold in that real estate. Iron County v. State Tax Commission (Mo.), 437 S.W.(2d) 665.
(1968) Not-for-profit corporation's property used for housing for the aged was not used for purposes purely charitable and was not exempt from taxation. Defenders' Townhouse, Inc. v. Kansas City (Mo.), 441 S.W.(2d) 365.
(1968) The charitable use doctrine depends upon the use made of the property sought to be exempted, and not solely upon the nature or stated purpose of the organization owning the property. Community Memorial Hospital v. City of Moberly (Mo.), 442 S.W.(2d) 290.
(1969) Nonprofit corporation which operated housing facilities for low income elderly was not entitled to tax exemption where facility was intended to be completely self-supporting and self-liquidating without any intention that gifts or charity were to be involved. Paraclete Manor of Kansas City v. State Tax Com'n. (Mo.), 447 S.W.(2d) 311.
(1975) Youth summer camp owned by religious and charitable organization which did not charge adequate fees to cover costs held to be exempt from taxation. Jewish Community Centers Association v. State Tax Commission (Mo.), 520 S.W.(2d) 23.
(1975) Certain hospitals held to qualify as tax-exempt charitable institutions. Residence quarters used by nurses held tax exempt as incident to hospital's basic objectives. Jackson County v. State Tax Commission (Mo.), 521 S.W.(2d) 378.
(1975) If any part of property is used for noncharitable purpose, the whole is taxable. City of St. Louis v. State Tax Commission (Mo.), 524 S.W.(2d) 839.

Section 6(a). Homestead exemption authorized. The general assembly may provide that a portion of the valuation of real property actually occupied by the owner or owners thereof, who are over the age of sixty-five, as a homestead, be exempted from the payment of taxes thereon, in such amounts and upon such conditions as may be determined by law, or the general assembly may provide for certain tax credits or rebates in lieu of such an exemption, but any such law shall further provide for restitution to the respective political subdivisions of revenues lost by reason of the exemption, and any such law may also provide for comparable financial relief to persons of such ages who are not the owners of homesteads but who occupy rental property as their homes.
(Adopted November 7, 1972)

Section 6(b). Intangible property exempt from taxation, when—local governments may be reimbursed, when. The general assembly may by general law exempt from taxation all intangible property, including taxation on the yield thereof, when owned by:

(1) Individuals; or

(2) Labor, agricultural or horticultural organizations; or

(3) Corporations or associations organized and operated exclusively for religious, charitable, scientific or educational purposes, no part of the net income of which inures to the benefit of any private stockholder or individual; or

(4) Hospitals which are exempt from payment of Missouri state income tax.

Any such law may provide for approximate reimbursement to the various political subdivisions, by the state, of revenues lost because of the exemption.

(Adopted November 7, 1972)

Section 7. Relief from taxation—forest lands—obsolete, decadent, or blighted areas—limitations—exception. For the purpose of encouraging forestry when lands are devoted exclusively to such purpose, and the reconstruction, redevelopment, and rehabilitation of obsolete, decadent, or blighted areas, the general assembly by general law may provide for such partial relief from taxation of the lands devoted to any such purpose, and of the improvements thereon, by such method or methods, for such period or periods of time, not exceeding twenty-five years in any instance, and upon such terms, conditions, and restrictions as it may prescribe; provided, however, that in the case of forest lands, the limitation of twenty-five years herein described shall not apply.

(Amended August 3, 1976)

(1954) Section 353.110 is authorized by section 7, Article X of the Constitution and does not conflict with section 6, Article X. Land Clearance for Redevelopment Auth. v. City of St. Louis (Mo.), 270 S.W.(2d) 58.
(1976) The exemption of not for profit cemeteries from taxation is from general taxes and not from special tax bills. Lakewood Park Cemetery Assn. v. Met. St. Louis Sewer Dist. (Mo.), 530 S.W.(2d) 240.

Section 8. Limitation on state tax rate on tangible property. The state tax on real and tangible personal property, exclusive of the tax necessary to pay any bonded debt of the state, shall not exceed ten cents on the hundred dollars assessed valuation.

Source: Const. of 1875, Art. X, § 8.

Section 9. Immunity of private property from sale for municipal debts. Private property shall not be taken or sold for the payment of the corporate debt of a municipal corporation.

Source: Const. of 1875, Art. X, § 13.

RSMo 1978

district, special assessment district, or park district, affected by sections 141.210 to 141.810.

141.230. Operation under law (certain class one counties).—1. The land tax collection law shall apply to all counties of class one which are now operating under the provisions thereof or which may hereafter elect to operate under the provisions of sections 141.210 to 141.810 by adoption of a resolution or order of the county court of such county, except that counties of the first class not having a charter form of government may not elect to operate under the provisions of sections 141.210 to 141.810. Any county court so adopting such resolution or order shall file a certified copy thereof within ten days after the adoption of said resolution or order with the clerk of the county court and with the collector of revenue for such county, and with the mayor and city collector or chief financial officer of each municipality in such county, as defined by section 141.220.

2. After the adoption of such resolution or order by such county court, any such municipality may by resolution or ordinance of its proper governing authority elect to adopt and come within the provisions of the land tax collection law, and thereafter shall cooperate with such county under the provisions of sections 141.210 to 141.810. Any such county or municipality which shall, in the manner provided herein, have elected to come within the provisions of sections 141.210 to 141.810 by adoption of such resolution, order or ordinance, may, after a period of one year from the effective date of such resolution, order or ordinance, adopt by similar means a resolution, order or ordinance, rescinding the election to adopt the provisions of the land tax collection law and certified copies of such resolution, order or ordinance shall be filed in the same manner as said original resolution, order or ordinance; provided, that such resolution, order or ordinance rescinding or nullifying the election to adopt the provisions of sections 141.210 to 141.810 shall not become effective for one year thereafter nor shall it invalidate or in any way affect any proceedings in rem for foreclosure which may have been instituted under the provisions of sections 141.210 to 141.810, but all such actions and proceedings so instituted while the provisions of said sections were in full force and effect shall be prosecuted to their conclusion and completion; provided further, that any county or municipality which may have operated under sections 141.210 to 141.810 prior to the enactment of this section may hereafter elect to terminate any further operation under sections 141.210 to 141.810 by proceeding in manner and form and to the same effect as though it had originally elected to operate under the provisions of sections 141.210 to 141.810.

3. Any city located partly within and partly without a class one county, which city and county now are or hereafter may be operating under the provisions of sections 141.210 to 141.810, may collect its delinquent tax bills, imposed against real property located in that part of such city situated within such class one county, pursuant to the provisions of sections 141.210 to 141.810; provided, however, that tax bills imposed against real estate, located in that part of such city outside of the limits of any such class one county, shall be collected under the provisions of the charter of any such city, or under such other provisions as may be provided by law.

Approved June 6, 1973.

[C. C. S. H. B. 149, 417, 425, 471 and 47]

TAXATION AND REVENUE: Tax relief in certain cases.

AN ACT relating to tax relief in certain cases, with an effective date.

SECTION
1. Definitions.
2. Time for filing and other procedural matters, how governed.
3. Credits, how applied, considered overpayment, when.
4. Accrued taxes and rent constituting taxes to be totaled—maximum amount allowable—allocation regulations, when.
5. Formula for determining credits—table to be prepared by director of revenue.
6. Effective date.

Be it enacted by the General Assembly of the State of Missouri, as follows:

Section 1. Definitions.—As used in this act the following words and terms mean:

(1) "Income", Missouri adjusted gross income as defined in section 143.121, RSMo, and increased, where necessary, to reflect the following:

(a) Social security, railroad retirement, and veterans payments and benefits;

(b) The total amount of all other public and private pensions and annuities;

(c) Public relief, public assistance, unemployment, and strike benefits received in cash;

(d) Amounts in excess of medical expenses received on account of personal injuries or sickness including amounts received under workmen's compensation, accident and health insurance, and similar arrangements;

(e) Dividends excluded by Section 116 of the Internal Revenue Code of 1954;

(f) Gain excluded from income by Section 121 of the Internal Revenue Code of 1954 and the capital gain deducted by Section 1202 of the Internal Revenue Code of 1954;

(g) No deduction being allowed for losses not incurred in a trade or business;

(h) Interest on the obligations of the United States, any state, or any of their subdivisions and instrumentalities;

(2) "Claimant", a person or persons claiming a credit under this act. If the persons are eligible to file a joint federal income tax return, then the credit may only be allowed if claimed on a combined Missouri income tax return or a combined claim return reporting their combined incomes and property taxes. A claimant shall not be allowed a property tax credit unless the claimant or spouse attained the age of sixty-five on or before the last day of the calendar year and unless claimant and spouse were residents of Missouri for the entire year;

(3) "Homestead", the dwelling in Missouri owned or rented by the claimant and not to exceed five acres of land surrounding it, as is reasonably necessary for use of the dwelling as a home. It may consist of part of a multidwelling or multipurpose building and part of the land upon which it is built. "Owned" includes a vendee in possession under a land contract and one or more tenants by the entireties, joint tenants, or tenants in common. It does not include personal property such as furniture, furnishings, or appliances, but may include a mobile home;

(4) "Rent constituting property taxes accrued", eighteen percent of the gross rent paid by a claimant and spouse solely for the right of occupancy of their homestead in the calendar year;

(5) "Gross rent", rental paid solely for the right of occupancy, at arms-length, of a homestead during the calendar year 1973 and later, exclusive of charges for any utilities, services, food, nursing, furniture, furnishings, or personal property appliances furnished as part of the rental agreement, whether or not expressly set out in the rental agreement. If the director of revenue determines that the landlord and tenant have not dealt at arms-length, and that the gross rent is excessive, then he shall determine the gross rent based upon a reasonable amount of rent. Gross rent shall be deemed to be paid only if actually paid prior to the date a return is filed. The director of revenue may prescribe regulations requiring a return of information by a landlord receiving rent certifying for a calendar

year the amount of gross rent received from a tenant claiming a property tax credit;

(6) "Property taxes accrued", property taxes paid, exclusive of special assessments, penalties, interest, and charges for service, levied on a claimant's homestead in 1973 or any calendar year thereafter. Property taxes shall qualify for the credit only if actually paid prior to the date a return is filed. The director of revenue shall require a tax receipt or other proof of property tax payment. If a homestead is owned only partially by a claimant and spouse, then "property taxes accrued" is that part of property taxes levied on the homestead which reflects the ownership percentage of the claimant and spouse. For purposes of this paragraph property taxes are "levied" when the tax roll is delivered to the collector of revenue for collection. If a claimant and spouse own a homestead part of the preceding calendar year and rent it or a different homestead for part of the same year, "property taxes accrued" means only taxes levied on the homestead both owned and occupied by the claimant, multiplied by the percentage of twelve months that such property was owned and occupied as their homestead during the year. When a claimant and spouse owns and occupies two or more different homesteads in the same calendar year, property taxes accrued shall be the sum of the taxes allocable to those several properties occupied by them as a homestead for the year. If a homestead is an integral part of a larger unit such as a farm, or a multipurpose or multidwelling building, property taxes accrued shall be that percentage of the total property taxes accrued as the value of the homestead is of the total value. For purposes of this paragraph "unit" refers to the parcel of property covered by a single tax statement of which the homestead is a part.

Section 2. Time for filing and other procedural matters, how governed.—Procedural matters related to filing a claim under this act, including the time for filing returns, refunds, deficiencies, interest, contents of returns, limitations, and penalties shall be determined pursuant to sections 143.481 to 143.996, RSMo, applicable to the income tax. The credit regarding the property taxes of a calendar year may only be claimed on a return for the calendar year or for a claimant's return for a fiscal year that includes the end of the calendar year. The credit shall only be allowed if it is claimed on a return which is timely filed, including any extensions.

Section 3. Credits, how applied, considered overpayment, when.—A credit for property taxes shall be allowed for the amount provided in section 5. If the amount allowable as a credit exceeds the income tax reduced by other credits, then the excess shall be considered an overpayment of the income tax.

Section 4. Accrued taxes and rent constituting taxes to be totaled—maximum amount allowable—allocation regulations, when.—The property taxes accrued and rent constituting property taxes accrued on each return shall be totalled. This total, up to four hundred dollars, shall be used in determining the property tax credit. The director of revenue shall prescribe regulations providing for allocations where part of a claimant's homestead is rented to another or used for nondwelling purposes or where a homestead is owned or rented or used as a dwelling for part of a year.

Section 5. Formula for determining credits—table to be prepared by director of revenue.—If the income on a return is seven thousand five hundred dollars or less, the property tax credit shall be determined from a table of credits based upon the amount by which the total property tax described in section 4 exceeds the percent of income in the following list:

If the income on a return is:	The percent is:
Not over $3,000	three percent
Over $3,000 but not over $3,500	three and one-quarter percent
Over $3,500 but not over $4,000	three and one-half percent
Over $4,000 but not over $4,500	three and three-quarters percent
Over $4,500 but not over $7,500	four percent

The director of revenue shall prescribe a table based upon the preceding sentences. The property tax shall be in increments of twenty-five dollars and the income in increments of one hundred dollars. The credit shall be the amount rounded to the nearest whole dollar computed on the basis of the property tax and income at the midpoints of each increment.

Section 6. Effective date.—This act shall become effective on October 1, 1973, with respect to the calendar year 1973.

Approved July 21, 1973.

[H. B. 46]

TAXATION AND REVENUE: Sales and use tax.

AN ACT to amend chapter 144, RSMo, relating to sales and use tax by adding thereto three new sections relating to the same subject, with a penalty provision.

SECTION
1. Amending clause.
144.011. Transfer of reusable containers not sale at retail.
144.121. Cities with city sales tax may audit pertinent state records—request, procedure—charge for facilities.
144.122. Unauthorized use of information prohibited, penalty.

Be it enacted by the General Assembly of the State of Missouri, as follows:

Section 1. Amending clause.—Chapter 144, RSMo, is amended by adding thereto three new sections to be known as sections 144.011, 144.121 and 144.122, to read as follows:

144.011. Transfer of reusable containers not sale at retail.—For purposes of sections 144.010 to 144.510 and the tax imposed thereby, the definition of "sale at retail" shall not be construed to include the transfer of reusable containers used in connection with the sale of tangible personal property contained therein for which a deposit is required and refunded on return.

144.121. Cities with city sales tax may audit pertinent state records—request, procedure—charge for facilities.—Notwithstanding the provisions of section 144.120, RSMo, any city, in which a city sales tax has been imposed, pursuant to the provisions of sections 94.500 to 94.570, RSMo, may inspect or audit any and all records of the state director of revenue pertaining to the administration, collection and enforcement of the city sales tax. The request by a city for inspection or audit of sales tax records and reports shall be made by written application signed

Senate Bill No. 132 was referred to the Committee on Judiciary.

Senate Bill No. 142 was referred to the Committee on Judiciary.

Senate Bill No. 149 was referred to the Committee on Elections.

February 27, 1973

FISCAL NOTE NO. W-51 FOR HOUSE COMMITTEE SUBSTITUTE FOR HOUSE BILLS NOS. 149, 417, 425, 471, 47

This proposal would allow a property tax credit on the state income tax for persons 65 and older with less than $7,500 in income.

Cost with 100% participation:

Loss in income tax revenue	$27,346,154
Cost of Administration	729,953
Loss From General Revenue	$28,076,107

	1st Year	2nd Year
Loss in income tax revenue	$13,673,077	$15,040,278
Cost of Administration	364,976	401,474
Loss to General Revenue	$14,038,053	$15,441,752

MARK L. EDELMAN
Director, Division of Budget

Prepared by:
Allen Scott
Budget Analyst

On motion of Mr. Rothman, the House adjourned until 4:00 P.M., Monday, March 5, 1973.

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x Relief
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Action Is Taken
House Committee

'FERSON CITY (Special) mbers of the House iittee on Municipal Corpo- s argued merits of two offering tax relief for the y Monday night, but no ac- vas taken on either mea-

: proposal, sponsored by Rep. James F. Conway, Louis, would take the "cir- breaker" approach to pro- tax relief.

circuit breaker bill would relief to those 65 or over an income of $6500 or less. ill includes a sliding scale would grant up to 75 per tax relief on no more than n property taxes or rent.

iding proponent of the cir- breaker bill was Jack imm, former Democratic sentative from University Schramm told the com- e the basic difference be- the two proposed forms of elief was who would bear urden of lost revenue.

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ramm said the circuit ker approach grants tax re- persons 65 or over based ed. He said the bill also l include relief for renters.

omestead tax relief bill in- iced by Rep. Phillip P. lia, D-Kansas City, would an exemption on the first assessed valuation of real e owned and occupied by ns 65 or over. It would no relief to renters.

aglia, who also is chairman e committee hearing the said his bill would cost the about $10 million to $12 ion in granting relief to the 00 home owners 65 or over e state. The legislator said loss could be offset by the lus in the state's general nue fund from anticipated lation growth and federal nue sharing funds.

Charles Valier, legal counsel for Gov. Christopher S. Bond, spoke on behalf of the governor, whom Valier said favored the circuit breaker legislation.

Valier said figures supplied by other states showed the homestead bill would cost about 25 per cent of the relief granted to administer, while the circuit breaker approach would cost only 1-2 of one per cent.

Several representatives of retired United Auto Workers from Kansas City spoke in favor of the homestead bill.

Gus W. Lueking called the circuit breaker bill a "pork barrel" for landlords. Lueking said tax relief granted renters under the circuit breaker bill would be eaten up when landlords increased rents.

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Under questioning from Chairman Scaglia, Schramm said the circuit breaker bill might allow landlords to profit from the rebates by raising rents. But Schramm, who ran unsuccessfully for lieutenant governor last fall, proposed a special subcommittee might be set up to provide some way to check rent increases.

"I don't think you ought to give up the whole bill when there is a solution that is workable," Schramm said.

Voters approved a constitutional amendment calling for tax relief for persons 65 or over in the November general election.

Kansas City Star, April 26, 1973

Elderly Tax Relief Gain

From The Star's Jefferson City Bureau

Jefferson City—Missouri's elderly with incomes of less than $6,500 a year would be eligible for some tax relief under legislation approved today by the Senate and was sent to the House. The vote was 30 to 0.

The bill, sponsored by Sen. Robert Young (D-St. Louis County), would implement a constitutional amendment adopted by voters last November authorizing the Legislature to provide tax relief to homeowners and renters 65 years old.

Relief would be granted to elderly property owners in the amount that local property taxes exceed 4 per cent of their incomes. The amount of property tax used in figuring relief could not exceed $400.

For instance an elderly person with an income of $3,500 would be responsible for property taxes amounting to 4 per cent of that—$140. If the individual's property taxes were $260 the state would allow a credit against income tax of $120. Persons who rent and do not own property could count 12 per cent of annual rent as property tax and then figure a claim on the same basis as the homeowner.

The bill is expected to cost about $15 million a year, based on an assumption that only about 45 per cent of those eligible will actually file a claim for relief. The House has approved a bill that would provide relief to persons with incomes up to $10,000 but the measure is viewed as impractical by the administration of Gov. Christopher Bond.

St. Louis Globe-Democrat, June 16-17, 1973

Legislature passes bill to givetax relief to older residents

By Associated Press

JEFFERSON CITY — Tax relief for Missouri residents 65 years or older has been approved by the legislature and sent to the governor.

The bill was passed Friday afternoon by Senate Democrats, after Republicans walked out in protest over treatment of Lt. Gov. William C. Phelps. The House passed the measure earlier Friday.

The bill, designed to help break the spiral of rising costs to persons on fixed incomes, would allow those with incomes of $7,500 or less to subtract from their tax returns an amount arrived at through a special formula.

The formula is: Four per cent of income, deducted from the amount of property taxes can be deducted from income taxes.

The limit on the property tax deduction is $400.

An example would be: If a property owner has an income of $7,500 and a tax bill of $400, he can deduct 4 per cent of the $7,500 — $300 — resulting in a credit of $100 on state income tax.

Renters can apply 18 per cent of their total tax bills to count as a property tax bill.

The legislation is expected to affect 130,000 persons over age 65, although experience in other states indicates only about one-third actually will participate. The cost to the state, in lost taxes, is estimated at about $17 million.

The effective date in the bill is Oct. 1.

Missouri's lawmakers came to the capitol for the final day of the session with several major bills still pending.

Final Status: PASSED, June 15, 1973